United States General Accounting Office

GAO

Report to the Honorable Benjamin L. Cardin, House of Representatives

February 2000

ACCRUAL BUDGETING

Experiences of Other Nations and Implications for the United States

G A O
Accountability ★ Integrity ★ Reliability

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Abbreviations

AAS	Australian Accounting Standards
ACC	Accident Compensation Corporation
AME	annually-managed expenditures
ANAO	Australian National Audit Office
CAF	capital acquisition funds
CFO	Chief Financial Officers
CICA	Canadian Institute of Chartered Accountants
DCA	Deficit Control Act
DoFA	Department of Finance and Administration
DOE	Department of Education
ERC	Expenditure Review Committee
FASAB	Federal Accounting Standards Advisory Board
FIS	Financial Information Strategy
FMI	Financial Management Initiative
FRA	Fiscal Responsibility Act
FRAB	Financial Reporting Advisory Board
GAAP	generally accepted accounting principles
GDP	gross domestic product
IP	Independency Party
JCPA	Joint Committee on Public Accounts
NAO	National Audit Office
NCOA	National Commission of Audit
OAG	Office of the Auditor General
OECD	Organization of Economic Cooperation and Development
OMB	Office of Management and Budget
PP	Progressive Party
PRA	Public Roads Administration
PSAB	Public Sector Accounting Board
PSASB	Public Sector Accounting Standards Board
PSNB	public sector net borrowing
PSNCR	public sector net cash requirement
PUMA	Public Management Service
RAB	resource accounting and budgeting
RAM	Resource Accounting Manual
RSSI	required supplementary stewardship information
SOE	State-Owned Enterprise
TBS	Treasury Board Secretariat

GAO
Accountability * Integrity * Reliability

United States General Accounting Office
Washington, D.C. 20548

Accounting and Information
Management Division

B-280850

February 18, 2000

The Honorable Benjamin L. Cardin
House of Representatives

Dear Mr. Cardin:

This report responds to your request that we look at the other nations that have moved toward the fuller use of accrual concepts in budget reporting with an eye to what help their early experiences might offer the United States. There are obvious and significant political, cultural and economic differences between the United States and these countries–Australia, Canada, Iceland, the Netherlands, New Zealand, and the United Kingdom. Nevertheless, their early experiences offer some insights as the United States considers ways to improve budget recognition of long-term commitments and continues to strive for improvements in government performance and accountability.

Accrual-based and cash-based costs are similar for many government activities. However, accrual measurement would move budget recognition forward for the costs of some programs such as insurance and pensions, which involve future cash flows. The opposite would be true for the purchase of capital assets: accrual measurement would provide a later recognition of the cost.

The U.S. federal budget is expected to provide information on the government's impact on the macro-economy as well as full information and appropriate incentives for resource allocation, for control over cash, for the recognition of future commitments, and for monitoring performance. As a result choices about the method of budget reporting require trade-offs among these multiple and potentially competing objectives.

We hope you find this report useful in your efforts to improve the federal budget process. We are sending copies to interested congressional committees and the Director of Office of Management and Budget. Copies will be made available to others upon request. If you or your staff have any questions about this report, please contact me on (202) 512-9573.

Sincerely yours,

Paul L. Posner

Paul L. Posner
Director, Budget Issues

Executive Summary

Purpose

Budgeting is the process by which we as a nation resolve the large number of often conflicting objectives that citizens and their representatives seek to achieve through government action. In that sense, nothing could be more important than debates about the budget. It is in the context of the budget debate that decisions are made about

- the federal government's fiscal policy, i.e., the relationship between spending and revenues;
- where the federal government will be involved and the allocation of resources across various program areas; and
- the tools the government will use to carry out these policies.

Given this, the nature and quality of the information used in the budget debate matters a great deal. Information permitting decisionmakers to look broadly across a range of ways to provide federal support—both spending and tax incentives—can improve the ability to make decisions about allocating resources and the best tools to use. Information on the long-term implications of different decisions is also important because they are not always obvious and may have major consequences. For these reasons, questions about changing the method of budget reporting[1] arise.

The method of budget reporting represents much more than a technical decision about how to measure costs; rather it reflects fundamental choices about the types of controls and incentives that are important in the decision-making process. Countries traditionally have relied on cash-based budgeting—recording amounts in the budget based on when cash is received or paid, regardless of when revenues are earned, resources are consumed, or liabilities are increased. These cash-based systems reflect the traditional focus of public sector budgeting on control, ensuring compliance with spending limits and assessing the short-term economic impact of fiscal policy. The United States, however, uses a system of both a cash- and obligation-based budget that permits greater control than solely a cash-based system. Recognizing that even this provided inadequate recognition and control for credit programs, in 1990 the United States embraced a form of accrual budgeting in that area.[2]

[1]In this report, the method of budget reporting refers to when and how transactions are recognized and measured in the budget.

[2]A long-standing exception to the reporting of outlays and receipts on a cash or cash equivalent basis is interest on public issues of public debt, which is recorded as it accrues.

In recent years, the United States and several other countries have undertaken reforms—some more sweeping than others—aimed at improving public sector financial and performance management. At the same time, in the United States, there has been increasing concern about the need to recognize the long-term cost implications of current commitments and decisions. Despite recent budget surpluses, the United States continues to face long-term budget pressures that stem in large part from the burgeoning costs of health and retirement programs prompted by the aging population. Simulations by GAO's and the Congressional Budget Office's (CBO) long-term budget models illustrate these budget pressures; even if projected budget surpluses are "saved" and used to pay down debt, growth in Social Security, Medicare and Medicaid threaten to crowd out discretionary spending. Both this concern and recent management reform efforts have challenged traditional thinking about cash-based and obligation-based budgeting systems and stimulated interest in the potential for accrual-based measurement—which records transactions in the period revenues are earned, resources are consumed, or liabilities are increased—to contribute to improved public sector management.

In the United States, two key concerns have increased interest in the potential for using accrual budgeting for programs other than credit programs: (1) a desire to improve the recognition of long-term commitments in the budget and (2) an interest in more directly linking improved cost and performance information to the federal budget process. As a result, there has been interest in the experiences of countries that have adopted accrual budgeting and what lessons might be learned from these experiences. Representative Benjamin Cardin asked us to examine

- countries' reasons for shifting to accrual budgeting,
- the ways other countries are using accrual-based information in the budget,
- the implications of accrual budgeting for decision-making,
- the key implementation challenges (technical and political) associated with the use of accrual budgeting, and
- issues raised by these countries' experiences that may be informative to the United States.

GAO's review included six countries—Australia, Canada, Iceland, the Netherlands, New Zealand and the United Kingdom.

Background

The federal budget serves as the primary financial plan of the federal government. Although budget decisions are inherently based on political choice, the method of budget reporting plays an important role by determining the information available and incentives provided to policymakers. Further, because the budget process serves as a key point of accountability, the way costs are measured in the budget can have significant consequences for managerial incentives. Therefore, choices about the method of budget reporting represent much more than technical decisions about how to measure cost; rather they reflect fundamental choices about the controls and incentives to be provided by the decision-making process.

The measurement bases discussed in this report—cash, accrual, and obligations—primarily affect the timing at which the budget recognizes costs. The structure or scope of budget accounts—i.e., whether budget costs are arranged based on organization, program, spending item, etc.—also helps determine the focus of decision-making, and the level of oversight and control placed on public spending, but it is a separate issue. The adoption of accrual-based measurement for budgeting may or may not be combined with changes to the account structure.

The recognition of costs in the budget (timing) is different for cash-, accrual-, and obligation-based reporting.[3]

- Cash-based budgeting records receipts and outlays at the same time cash is received or paid, without regard to when the activity generating the revenue, consuming the resources, or increasing the liability occurs.
- Accrual-based budgeting records transactions in the period when the activity generating the revenue, increasing the liability or consuming the resources occurs—regardless of when the associated cash is actually paid or received. Although the costs recorded for accrual-based budgeting need not be identical to those used for accrual-based accounting, the term accrual budgeting usually has been used to refer to the recording of budget costs based on financial accounting standards. As a result, accrual-based appropriations, by reflecting the costs incurred during a fiscal year, generally are similar to the expenses reported in a private sector operating statement.

[3]For additional explanation of the difference in these measurement bases, see chapter 1.

- Obligation-based budgeting focuses upon controlling the legal obligations or commitments entered during a period. Obligation-based budgeting records financial transactions, primarily when orders are placed, contracts are awarded and other similar transactions are made that will require payment during the same or a future period.

The U.S. budget is neither accrual nor pure cash; it is obligation-based because it focuses upon controlling the legal obligations or commitments entered into during a period. Obligation-based budgeting involves three stages: (1) the Congress must enact budget authority up front before government officials can obligate the government to make outlays, (2) government officials commit the government to make outlays by entering into legally binding agreements, and (3) outlays (cash disbursements) are made to liquidate obligations. However, with limited exceptions,[4] the amounts to be obligated are measured on a cash or cash equivalent basis and the unified budget deficit/surplus[5]—the key focus of the policy debate—represents the difference between cash receipts and cash outlays in a given year.

The use of cash-based measurement in public sector budgeting has several advantages. Perhaps most notably, cash has been a widely used and traditionally accepted measure of the government's impact on the economy.[6] Further, because it can be tracked, cash fits well with the traditional public sector budgeting focus on control and on ensuring

[4]The U.S. budget uses accrual measures to recognize the government's costs for certain programs. For more information see chapter 1.

[5]Under budget concepts set forth in the *Report of the President's Commission on Budget Concepts*, the unified budget is a comprehensive budget in which receipts and outlays from federal and trust funds are consolidated. When these fund groups are consolidated to display budget totals, transactions that are outlays of one fund group for payment to another fund group (that is, interfund transactions) are deducted to avoid double counting.

[6]A cash-based budget is not the only measure available to assess the impact of government activities on the economy. In the United States, for example, the official national income and product accounts (NIPAs) provide a picture of government activities in terms of production, distribution, and use of output. There are a number of major differences in the treatment of federal receipts and expenditures in the NIPAs and their treatment in the unified budget, including adjustments for timing of payments. For example, the unified budget counts receipts for corporate taxes when they are paid, whereas NIPA counts them when the liability is accrued. NIPA and the unified budget also differ in their treatment of investment and capital consumption. The unified budget reflects all expenditures of the federal government including investment while the NIPA budget shows current expenditures and thus excludes investments and includes the consumption of fixed capital (depreciation).

compliance with spending limits. In addition, for most government activities the time between the occurrence of the underlying transaction resulting in a government liability and the cash outlays necessary to liquidate the liability is relatively short. Therefore, cash-based measurement generally provides both adequate information and control.

Despite these advantages, two reinforcing issues have stimulated interest in the use of accrual measurement for public sector management. At the governmentwide level, costly incidents, such as the deposit insurance crisis in the United States and the issuance of guarantees in New Zealand, served to highlight shortcomings of cash reporting for signaling the long-term implications associated with some policy decisions and the need for a more complete picture of a government's financial condition. At the organizational level, the desire to improve the efficiency and effectiveness of government operations through more performance-focused management has placed an emphasis on understanding and managing costs. Faced with concerns about the sustainability of government activities and with demands for more result-oriented management systems, other countries moved towards accrual-based measurement for financial reporting and a few moved from cash-based budgeting to accrual budgeting. Similar concerns have raised questions about whether the current U.S. cash- and obligation-based budget adequately (1) presents information on the long-term sustainability of government activities or (2) matches cost to government performance in a way which effectively supports management reform efforts.

For some activities, such as credit and pension programs, cash-based measurement is incomplete and potentially misleading. As a result, the true cost to the government as a whole, and/or the cost of particular goods or services, may be misstated. For example, GAO has argued that the cash-based measure understates the costs of commitments already entered into for federal insurance programs.[7] Further, the cash flows for some items, such as asset purchases, may not adequately match annual resources consumed with the provision of goods and services. As a result, it may be difficult to fully assess the costs associated with a given level of performance.

[7]See *Budget Issues: Budgeting for Federal Insurance Programs* (GAO/AIMD-97-16, September 30, 1997).

In recent years, the United States and other countries have undertaken reforms aimed at improving public sector financial management and performance while enhancing transparency and accountability. These reforms have served to highlight the need for more complete and comparable cost and performance information. For example, it has been recognized that adequately assessing performance under more result-oriented management systems requires information beyond the cash flows in a given period and more consistent and credible cost data across programs and accounts. As a result, the United States government began to produce audited agency and governmentwide financial statements to provide accrual-based information on the cost of government activities. The challenge, however, remains of how to integrate this information into the budget process so that it effectively supports policy decision-making and management reform objectives.

Results in Brief

Within broader reform efforts, several countries have adopted accrual budgeting as a tool to address concerns about public sector performance, sustainability of government activities, and accountability. Much more than an isolated technical exercise, the shift to accrual budgeting has generally reflected much wider and more fundamental reform efforts. Although these countries are still in the early stages of developing and implementing accrual budgeting, proponents believe that it provides more complete information and better incentives to address these concerns.

Accrual budgeting has been used as a tool to support performance-focused management because, in some cases, it more clearly links the total cost of resources used to the performance achieved. For example, New Zealand and Australia[8] combined accrual budgeting with output budgeting to support more decentralized management systems that hold managers responsible for results while reducing controls over inputs (specific spending items). Under these systems, appropriations are made not for specific items, such as salaries or supplies, but for funds to provide specific outputs (goods and services delivered on behalf of the government). Managers are then held accountable for delivering the specified outputs within the appropriated amount. This makes understanding the total costs (including items such as accrued employee pensions to be paid in the future) associated with a given result important both for deciding on

[8]The Netherlands has applied a similar approach on a limited basis to select departments.

appropriation amounts and for ensuring accountability. Other countries, such as the United Kingdom, which chose to incorporate accrual measurement into the budget to reflect more completely and systematically the cost of resources consumed, have stopped short of adopting output-based appropriations.

Proponents also believe that accrual budgeting improves incentives to address the longer-term implications of current decisions by better reflecting year-to-year changes in assets and liabilities. For example, New Zealand officials attributed reforms in both its employee pension program and an accident insurance program to the fact that costs became more apparent in the budget. Proponents also believed accrual budgeting improves accountability and control by enhancing the consistency of budget information, even though it raises some new oversight issues. For example, proponents saw improving the consistency between the budget and the financial statements as important to enhancing oversight.

Although some officials and experts cited benefits, others expressed skepticism and concerns about the use of accrual budgeting. While proponents noted that information on cash flows is available under accrual budgeting, other experts expressed concern about a reduction in the transparency of information on the government's cash borrowing requirement. Another potential reduction to transparency stemmed from the fact that accrual budgeting requires more sophisticated understanding of financial reporting standards and underlying assumptions. Along these lines, concerns were raised about the ability to clearly track and control government spending. In addition, some thought that some benefits, such as improved asset registers, could be achieved through accrual accounting and reporting alone without using accrual-based measurement for budgeting. Finally, countries faced a number of implementation challenges, such as the identification and valuation of assets.

Despite obvious and significant political, cultural, budget, and economic differences, these countries' early experiences with accrual budgeting provide some valuable insights for the United States. Their experiences, however, must be seen in the context of their particular situations. The challenge is how to translate useful ideas developed in a parliamentary political system to the U.S. system in ways that could improve its decision-making process while protecting its unique institutional needs. In analyzing the benefits cited by other countries and the potential for similar benefits in the United States, it is important to consider that the legislative bodies in a parliamentary system of government and the Congress of the United States

differ, especially in the role each plays in the budget process. The U.S. Congress is an independent and separate branch of government that takes a more active role in resource allocation decisions than the parliaments in GAO's case study countries. Many important decisions that, in the United States, are debated during the annual appropriations process occur in case study countries before the budget is presented for parliamentary approval. Also, most case study countries generally deal with the approval of obligations through executive branch controls whereas in the United States congressional approval (budget authority) is required before executive branch departments can obligate funds. Further, most case study countries used purely cash reporting for budgeting before adopting accrual budgeting. In contrast, the United States' obligation-based budgeting already captures many obligations not apparent in a purely cash system. These differences are likely to influence perspectives on the trade-offs associated with the use of accrual budgeting, particularly in terms of accountability and legislative control issues.

Any reform effort should begin with consideration of the overarching managerial and control objectives embodied within the United States' institutional system. While concerns have been raised that the U.S. obligation-based system may not adequately reflect all long-term commitments or properly align budget cost recognition with the consumption of resources, it offers other benefits in terms of up-front control of obligations. Thus, the challenge for the U.S. system is to see if accrual concepts can be adapted to address the unique budgetary needs of the Congress as well as the executive branch.

The up-front funding requirement under an obligation-based budget helps ensure control but does not necessarily align budget cost recognition with the consumption of resources. Conversely, accrual measurement can be used to better match costs with the consumption of resources, but in its simplest form does not necessarily provide up-front control over entering into legally binding commitments. Thus, choices about the basis of budgeting depend in part on the relative importance one places on recognizing and controlling the full costs at the time decisions are made versus matching budget recognition to the period resources are actually consumed.

GAO believes that the selective application of accrual budgeting to certain long-term commitments can strengthen the information and accountability for these costs. In addition, decision-making could benefit from incorporating accrual measurement into the budget in ways that better

match the cost of resources consumed with the performance achieved without forfeiting budgetary control. Finally, even without changing the measurement basis of budgeting to accrual, congressional oversight and managerial decision-making could be enhanced by better integration of supplemental accrual-based information (e.g., net present value for long-term commitments and unit cost for goods and services) into the decision-making process.

Earlier recognition can promote timelier action to address some long-term commitments before they become too unwieldy or burdensome. For many government activities, such as salaries or grant payments, there generally would not be significant differences in the timing of budget recognition between cash and the annual accrued costs. Accrual measurement, however, would advance the recognition of costs for commitments such as pensions and insurance that involve cash flows over many years. Such an approach might also be helpful for selected tax expenditures where current cash flow numbers fail to capture their longer-term effects on government revenues (e.g., the timing differences associated with certain pension and savings incentives). Conversely, for capital assets, accrual measurement would delay cost recognition by spreading costs over the lives of the assets. Thus, while accrual budgeting matches budget costs with the provision of goods and services, it raises issues about up-front cost recognition and control for capital assets.[9]

For these reasons, adopting accrual budgeting selectively within an obligation-based control system may improve information while preserving up-front control within the United States' unique separation of powers system. Specifically, accrual measurement within the obligation-based budget might result in better budget information and incentives for decision-making for programs like government employee pensions or insurance in which cash-based measurement may fail to capture the magnitude of the government's commitment. The approach developed for

[9]While the full cost of an asset may not be appropriated up front, case study countries established a number of compensating controls in an attempt to alleviate control concerns. In most cases, case study countries require appropriations for the annual cash required to purchase assets. A number of case study countries also established supplemental approval processes for capital projects. In New Zealand, managers are not allowed to change the structure of their balance sheets without legislative approval; this is aimed at preventing managers from running down their asset bases to artificially lower the price of outputs. However, legislative approval is not required for asset purchases below a certain amount if the department can fund them from depreciation reserves. See chapter 3 and country appendixes for additional information.

credit programs in the Federal Credit Reform Act of 1990 is an example of the selective application of accrual budgeting. On the other hand, the obligation-based approach could be retained for items like capital, for which the use of accrual budgeting without additional compensating controls would reduce the up-front control provided by the United States' current system.

In terms of providing a more complete picture of the long-term sustainability of a government's activities, it is important to note that accrual budgeting as implemented by the case study countries does not cover social insurance commitments. The extent to which accrual budgeting based on financial accounting standards can be used to improve the recognition of long-term issues is limited. Although social insurance is generally viewed as a government commitment likely to result in a future cash outlay,[10] it is not judged to be a liability according to accounting standards in these countries. Thus, none of them have budgeted for such commitments on an accrual basis. This would also be the case if the United States adopted accrual budgeting based on its federal accounting standards.[11]

As a result, accrual budgeting as implemented by case study countries is not the answer to questions of how to improve the budget recognition of

[10]Under current law, U.S. Social Security benefits can only be paid from the trust fund balance.

[11]Accounting standards in case study countries do not recognize future social insurance payments as a liability because they are uncertain. For example, the government can change these programs. Similarly, accounting standards developed for the U.S. federal government do not view social insurance as a liability because the level of future benefits is considered to be uncertain. Proponents of these standards point out that the underlying laws establishing a claim to payments can be (and have been) changed over time. Also, they cite that estimates change greatly depending on economic assumptions and have changed overtime. For example, the 1983 legislative changes to the Social Security program were expected to maintain a positive fund balance until 2063; however, by current intermediate cost assumptions the fund will run out three decades sooner. However, many others believe that a liability should be recognized for the net benefits expected to be paid in future periods to current participants. Agreement on the final standards calling for disclosures but not recognizing a liability for such payments was a compromise between the two positions. While not included as a liability, information on social insurance is to be included as "required supplementary stewardship information" (RSSI). The requirement for RSSI was established in recognition of the federal government's unique stewardship role over certain resources entrusted to it. The standards require that an entity responsible for a social insurance program include in its financial report, as RSSI, a description of the social insurance program, how it is financed, how benefits are calculated, and its financial and actuarial status.

long-term social insurance commitments. If formal recognition of social insurance commitments in the budget is desired, other methods of incorporating accrual concepts into the budget could be developed. Some possible approaches for Social Security, for example, might include recasting the Social Security surplus by recording outlays in the same amount as social insurance receipts to reflect the government's commitment to spend those amounts on benefits in the future. Alternatively, revenue recognition of the surplus receipts might be deferred until they are used to make payments in the future. Another possibility would be to track the expected cost of the government's long-term commitments in the budget for each budget account or program alongside its cash-based budget authority and outlays. These ideas and others would need to be explored in detail by experts in the field of budgeting to determine their workability and potential benefits. Suggestions have been made that a budget concepts commission is needed to address a number of issues, including Social Security; it could be the proper forum to fully develop new budgeting ideas.

Congressional oversight could also be enhanced by better matching of the cost of resources consumed with the performance achieved in a manner that does not forfeit budgetary controls. For instance, GAO's previous review of agencies' performance plans shows that some agencies have been able to develop approaches that make basic and useful connections between proposed spending and performance goals within the current budget framework.[12] While full accrual budgeting is not necessary to continue improving such connections or to enhance the quality of cost information, efforts will be necessary to mitigate the danger that such cost information may be treated as a supplemental exercise rather than considered integral to the budget debate. Also, accrual budgeting could be used to better reflect resources consumed without moving to output-based appropriations. For example, mechanisms to charge programs for the use of capital assets over time, such as capital acquisition funds,[13] could better align the cost of capital with its use while preserving the up-front control. This type of mechanism is one way that accrual-based cost could be

[12] *Performance Budgeting: Initial Agency Experiences Provide a Foundation to Assess Future Directions* (GAO/T-AIMD/GGD-99-216, July 1, 1999).

[13] Capital acquisition funds would finance the purchase of capital assets with up-front funding using funds borrowed from the Treasury. They would then rent the assets to one or more program accounts, charging a rate sufficient to cover repayments of principal and interest on the Treasury loan.

incorporated in the budget at the agency level while preserving the cash and obligations basis for the government as a whole.

GAO Analysis

Accrual Budgeting Adopted as Part of Broader Reform Efforts

In case study countries, the use of accrual budgeting has been linked intrinsically with broader reform efforts driven by concerns about the size, role, and effectiveness of the public sector. These reforms have generally sought to improve government activities through improved transparency and/or more performance-oriented management. However, while accrual budgeting has generally been much more than an isolated technical exercise and reflective of wider and more fundamental reform efforts, the impetus for and the magnitude of change varied significantly across the countries reviewed. Some countries, such as New Zealand and Iceland, were motivated by large deficits or concerns over the sustainability of government activities. Others, such as the United Kingdom and Australia, undertook changes to make general improvements in public sector management.

The implications of a shift to accrual budgeting need to be seen in the context of these broader reform efforts. For example, in New Zealand, the adoption of accrual accounting and budgeting was only one component of sweeping reforms undertaken to restore its economy after several years of serious economic difficulties. As part of these reforms, New Zealand not only changed its reporting from cash to accrual but also comprehensively and fundamentally restructured the role of the national government in the economy and radically changed the accountability relationship between the government and departmental executives. To varying degrees, the other case study countries also undertook accrual budgeting as part of broader financial and performance management reforms.

Countries Vary Significantly in the Design and Implementation of Accrual-based Budgeting Systems

Not surprisingly, each country's reform objectives and budget control needs influenced the approach taken to designing and implementing its accrual budgeting framework. Approaches varied with respect to

- the extent to which accrual budgeting is used as part of an output budgeting framework in which the budget is intrinsically linked to performance,

- the scope of budget items measured on an accrual basis, and
- the organizational level to which accrual budgeting is applied.

Four countries—New Zealand, Australia, Iceland, and the United Kingdom—have chosen, or are expecting, to implement accrual budgeting for most budget items at both the departmental and central government levels. Their approaches (1) use the same accounting standards[14] for both financial reporting and budgeting and (2) incorporate primary financial statements[15] roughly similar to those found in private sector financial reporting into the budget process. With two notable exceptions—the exclusion of capital and centralization of pension costs in Iceland and the United Kingdom's exclusion of revenues—these countries apply accrual-based measurement using financial accounting standards to virtually all budget items at both the departmental and the governmentwide levels.[16]

Two of these four countries—New Zealand and Australia—placed significant emphasis on directly linking the budget (including the basis of appropriation) with their overall performance and accountability structures. In these two countries, the shift to accrual measurement occurred concurrently with a shift to output-based appropriations. In general terms, output-based appropriations provide funding for the total resources required to produce an "output" (a good or service produced by departments) including costs that do not require a cash outlay, such as depreciation. The United Kingdom has also proposed an accrual budgeting framework that aligns resources to performance, but has stopped short of adopting output-based appropriations. Iceland's approach reflects a greater emphasis on recognizing the cost of the long-term commitment for employee pensions at the governmentwide level rather than allocating costs to particular goods and services.

[14]Some countries' accounting standards are not fully accrual-based. For example, Iceland reports physical assets on a cash basis and the United Kingdom accounts for revenues on a cash basis.

[15]Traditionally, primary financial statements include (1) a balance sheet which presents the total balances of assets, liabilities, and net position of an organization as of a specific time, (2) a statement of operations which provides accrual-based information on an organization's flows of revenues and expenses and other changes in the organization's net resources during a period of time, and (3) a statement of cash flows which presents the cash flows of an organization during a period of time.

[16]For the most part, social insurance is not recognized as a liability under financial accounting standards used in the case study countries and the United States. See footnote 8.

The other two case study countries, Canada and the Netherlands, have applied accrual budgeting on a more limited basis to specific budget items or departments. Canada currently applies accrual budgeting to public sector employee pensions and accounts payable at both the department and the governmentwide levels. However, Canada is considering shifting capital to an accrual basis with the intent of better integrating its financial management system. The Netherlands has applied accrual budgeting, using an approach similar to the New Zealand and Australia output-based models, for a select number of agencies (subunits within ministries) but is still undecided about its application governmentwide.

Countries Measure Budget Deficit/Surplus Differently

Another key difference among countries' approaches is the basis used to measure the governmentwide deficit/surplus. New Zealand reports its deficit/surplus using the accrual-based net operating result. Under Iceland's approach, the main focus of the budget debate is the Operating Statement which includes estimates of revenues and expenses on both an accrual and a cash basis. However, the aggregate operating result is reported only on an accrual basis. Australia has chosen to use a "fiscal balance" measure which is derived by adjusting the accrual-based operating balance to better approximate cash and the national investment/saving gap. Under the current Canadian system, two measures of fiscal position (deficit/surplus) are used: (1) the financial balance, or cash requirement which approximates the country's financing needs and (2) the budgetary balance—its primary fiscal measure—that includes pensions, accounts payable, and other accrual-measured items[17] even though cash is not needed immediately. In the Netherlands, the governmentwide deficit/surplus is reported on a cash basis.

Accrual Budgeting Used as a Tool in Addressing Performance Management Challenges

Proponents described accrual budgeting as a useful, if not critical, tool in addressing performance management challenges. Accrual-based measurement is viewed as eliminating distortions that are inherent in cash-based reporting, such as reporting pensions as they are paid rather than as they are earned, and thus better matching the budget recognition of cost with the expected performance results. As a result, accrual budgeting is credited with supporting broader performance management reform efforts in several ways, such as

[17]For additional details see appendix II on Canada.

- reflecting and supporting more decentralized and performance-focused accountability systems;
- facilitating more competitive, businesslike approaches to providing government goods and services; and
- encouraging more efficient and effective resource management, particularly with respect to capital assets.

For example, New Zealand and Australia[18] combined accrual budgeting with output budgeting to support more decentralized management systems that hold managers responsible for results while reducing controls over inputs (specific spending items). Under these systems, appropriations are made for outputs (goods and services delivered on behalf of the government), rather than for specific items, such as salaries or supplies. These systems aim to create a more businesslike environment in which an appropriation can be thought of as the "price" received by the department and paid by the government for a given output. Managers are then held accountable for delivering the specified outputs within the appropriated amount. This makes understanding the total costs associated with a given output, not just the immediate cash outlays, important to ensuring accountability. From the department's perspective, outputs must be "priced" so that appropriations will be sufficient to cover costs over time. From the perspective of policymakers as the purchasers of goods and services, only by understanding the complete costs, including those that do not result in immediate cash flows, can an organization's performance be fully assessed and compared to other organizations, both public and private. In this way, accrual measurement in the budget is used to hold managers accountable in these more decentralized systems. As a result, some proponents view accrual budgeting as critical to establishing more performance-focused management systems. Other countries, such as the United Kingdom, have chosen accrual budgeting in an attempt to reflect more completely and systematically the cost of resources consumed, but have stopped short of adopting output-based appropriations.

Accrual budgeting also was viewed as beneficial in the area of capital asset management. In addition to one-time benefits such as the identification and valuation of assets, accrual budgeting was credited with creating better incentives for ongoing asset management by matching the costs of an asset with its use and better recognizing the cost of holding capital. However, some doubts and concerns about the advantages of accrual budgeting for

[18]The Netherlands has applied a similar approach on a limited basis to select departments.

assets were also expressed, some similar to concerns that would apply in the United States. For example, asset valuation was difficult and often subjective. Thus, using the asset values as the basis for budgeting for depreciation was questioned. Concerns also were expressed over whether managers would actually "save" the amounts appropriated for depreciation to use for asset replacement and whether they might choose to operate using obsolete assets to avoid cost-of-capital charges. Proponents, however, argue that compensating controls can serve to alleviate these concerns. Since accrual budgeting has been in place for only a relatively short period in any of the case study countries, it is too soon to determine if these concerns are valid.

In addition, experts in the United States expressed concern about a reduction of up-front control over asset purchases relative to that currently provided under the United States' obligation-based budget. Whereas case study countries generally deal with the approval of obligations, such as asset purchases, through executive controls, in the United States congressional approval (budget authority) is required for departments to make such obligations.

Accrual Budgeting Used to Improve Information and Incentives With Respect to the Sustainability of Government Activities

Many of the countries that have adopted accrual budgeting have done so, in part, with the expectation that it will help decisionmakers better understand the long-term sustainability of government policies. Proponents saw accrual budgeting as useful for assessing the sustainability of government policies by providing

- better budgetary recognition of liabilities and
- a more complete set of information to assess a country's financial health.

For example, New Zealand and Iceland credited accrual budgeting with highlighting the longer-term consequences associated with public sector employee pension programs. In Iceland, accrual budgeting showed the consequences of wage negotiations on future public sector employee pension costs. The full costs of these agreements were not fully realized by the public until the adoption of accrual budgeting led to the recognition of the liability in the budget estimates. Icelandic officials informed us that there is no longer public support for decisions that are so costly in the long term. Similarly, New Zealand officials decided to discontinue the defined benefit public employee pension program after pension liabilities were recognized on the balance sheet and the expense incurred was included in

the budget. More recently, as a result of recognizing the liability from providing accident coverage, the New Zealand government initiated efforts to reform the Accident Compensation Corporation program.

Furthermore, proponents suggested that accrual budgeting provided decisionmakers with a more comprehensive picture of a government's financial condition by better integrating financial statement information—including the balance sheet, operating statement, and cash flow statement—into the decision-making process. However, none of the case study countries budget for long-term commitments, such as social insurance, on an accrual basis. This is because, in their accrual budgets, countries have generally mirrored their financial accounting standards that do not consider such commitments to be liabilities.

Accrual Budgeting Helps Address Some Accountability and Control Issues but Raises Others

Proponents also believe accrual budgeting improves transparency and accountability. For example, officials in New Zealand informed us that cash-based budgeting followed inconsistent and complex practices understood by only a few practitioners. In contrast, proponents believe that the decision to use accrual-based financial accounting standards as the basis for budgeting improved the credibility of the budget because these standards are developed by an independent body, are well documented, and are generally accepted and understood. In addition, they viewed using the same measurement basis for budgeting and financial reporting as enhancing oversight. Others disagreed with this view, believing that the increased complexities associated with the use of accrual budgeting may reduce transparency and control. Because accrual measurement focuses on recognizing the financial effects of economic events, it is necessarily dependent on interpretations and judgments about both when those economic effects occur and what their ultimate costs will be. Some of the concerns focus on features that, depending on the approach used, could be part of accrual budgeting, such as (1) cash may be appropriated for noncash expenses such as depreciation which do not require immediate cash outlays, (2) some of the assumptions and judgments necessary to develop accrual estimates are complex and may have no clear resolution, and (3) when combined with output-based budgeting, wide discretion is provided to departments over the use of resources. Under these conditions, effective oversight depends on the use of sophisticated financial and performance management principles such as asset/liability management and benchmarking.

Some Express Skepticism About Use of Accrual-Based Budgeting

Despite perceived benefits, some officials and other budget experts expressed skepticism about the value or feasibility of accrual budgeting. A key concern expressed by some government officials and other experts was that accrual budgeting does not focus sufficient attention on the government's borrowing requirement and thus fails to adequately address the central government's stewardship role for the current and future economy. As noted earlier, there was also some concern because decisionmakers have encountered difficulties understanding the complexities involved in the use of accrual budgeting because of the technical issues and assumptions on which accrual measurement is based. For example, the National Audit Office in the United Kingdom noted that while accrual measurement may provide a more comprehensive basis to assess costs, it is likely to be less precise than cash. Officials from several countries commented on the difficulties encountered in valuing some assets, including the subjective nature of valuations in some cases. For example, several country officials acknowledge the difficulties associated with valuing unique assets such as military equipment or national monuments which do not have alternative uses or readily available comparisons in the private market.[19] Nevertheless, asset values are particularly important because they serve as the basis for the annual depreciation charge included in an accrual budget.

Implications

Despite obvious and significant political, cultural, and economic differences, the early experiences of other countries with accrual budgeting provide insights that may be helpful as the United States considers ways to improve budget recognition of long-term commitments and continues to strive for increased government performance and accountability. In analyzing the benefits cited by other countries and the potential for similar benefits in the United States, it is important to consider key differences between (1) the legislative bodies in a parliamentary system of government and the Congress of the United States,

[19] In the United States, there has been debate surrounding the treatment and valuation of unique governmental assets such as weapon systems and heritage assets. In considering this issue, the Federal Accounting Standards Advisory Board (FASAB) suggested that (1) the value of some federal assets, such as museums and national parks, may be indeterminable and (2) allocating the costs of assets such as military weapons systems to accounting periods may be meaningless. In response to these difficulties, FASAB required a new category of financial reporting, "required supplementary stewardship information," which is to accompany financial statements, but not be included directly on the balance sheet.

especially in terms of the role each plays in the budget process, (2) the methods of budget reporting already in place in each country, and (3) the relative stages of development of financial reporting and budgeting processes. In addition, the implications of other reforms undertaken at the same time as accrual budgeting need to be considered. Given the differences between the United States and the other countries in all of these factors, it is unlikely that the United States would achieve all of the benefits claimed by case study countries. However, some benefits could result from expanding the selective use of accrual budgeting, as has already been demonstrated for credit programs.

The implications of various accrual budgeting approaches must be evaluated against the objectives sought in the U.S. budgeting system. Choices about the appropriate method of budget reporting are complicated by the multiplicity of the budget's uses and users. The federal budget is simultaneously asked to provide full information and appropriate incentives for resource allocation, control over cash, recognition of future commitments, and monitoring of performance. Given the multiple and potentially competing objectives, choices about the method of budget reporting involve trade-offs. For example, control over spending is greatest if the budget recognizes the complete costs at the time the spending decision is made while assessing performance and its costs is generally best supported by recognizing resources as they are used to produce goods and services.

Thus, changing the basis of budgeting is much more than a technical change; it represents choices among the uses and functions of the budget. An accrual budget can be used to better match recognition of budget costs with the use of resources and to capture changes in assets and liabilities. However, despite some acknowledged limitations in these areas, the obligations basis of budgeting used by the United States provides its own benefits, particularly for up-front budgetary control. Since the United States operates under the principle of the separation of powers the constitutional provision "no money shall be drawn from the Treasury but in the consequence of appropriations made by law" is particularly important.[20]

[20]U.S. Constitution, Article I, Section 9, Clause 7.

Whether accrual budgeting as implemented by the case study countries would provide earlier budget recognition of costs depends on the item. For many government activities, such as salaries or grant payments, there generally would not be significant differences between cash and the annual accrual-based costs. However, for programs which involve future cash flows such as insurance and pensions, accrual measurement would move cost recognition earlier to when the insured event occurs or benefits are earned, even if cash flows do not occur in the budget year. In contrast, for capital assets, accrual measurement would delay recognition relative to obligation-based budgeting by matching its costs not with the purchase but with the consumption of the asset. For example, while an obligation-based budget recognizes the full cost of an asset and permits congressional control by requiring up-front authority for the asset's full cash purchase price before the purchase is made, generally an accrual budget would not show a cost for an asset until it begins to be depreciated—after it has been purchased and put into service.[21]

[21]Case study country officials, however, pointed out that their accrual budgeting frameworks have compensating controls. Although treatment varies among case study countries, appropriations are generally required for the annual cash required to purchase assets. However, these annual cash amounts may not represent the full cost of the assets. In some cases, legislative approval is not required for asset purchases below a certain amount if the department can fund them from depreciation reserves.

The fact that a shift to accrual budgeting would reduce control over capital purchases relative to the obligation-based budget and would not make a significant difference for most budget items raises serious questions about whether full accrual budgeting would provide sufficient benefits to warrant its full adoption in the United States. However, adopting accrual budgeting selectively within an obligation-based control system could be beneficial. It would provide a means for improving budget information and incentives for decision-making in cases where cash-based measurement does not capture the full cost of the government's commitment while preserving the up-front control of the obligation-based budget. The approach developed for credit programs in the Federal Credit Reform Act of 1990 is an example.[22] Similar treatment might be extended to other areas in the budget for which cash basis reporting does not adequately represent the extent of the government's commitment, such as employee pensions and retiree health benefits or federal insurance programs.[23]

However, there are limits to which an accrual measurement based on financial accounting standards improves recognition of long-term issues. For example, accrual budgeting as implemented by the case study countries does not fully deal with social insurance commitments. In general, the countries have chosen to mirror their financial accounting standards in their accrual budgets. Although social insurance programs may be widely viewed as government commitments likely to result in future cash outlays, they are not currently judged to be liabilities under accounting standards in these countries. Thus, none of them have budgeted for such commitments on an accrual basis. This would also be the case if the United States adopted accrual budgeting based on its federal accounting standards.

As a result, accrual budgeting based on current financial accounting standards is not the answer to questions about improving the budget recognition of long-term social insurance commitments. If formal recognition of social insurance commitments in the budget is desired, other methods of incorporating accrual concepts into the budget could be

[22]For credit programs, obligations measured on a cash basis sent the wrong signals about the cost of the government's commitment, while obligations measured on an accrual basis—as required by credit reform—showed the expected cost to the government over the life of the credit instrument.

[23]See *Budget Issues: Budgeting for Federal Insurance Programs* (GAO/AIMD-97-16, September 30, 1997).

developed. For programs with current surpluses that are dedicated for long-term cost commitments like Social Security, the budget might record outlays in the same amount as social insurance receipts to reflect the government's commitment to spend those amounts on benefits in the future. Alternatively, it might defer revenue recognition until the receipts are used to make payments in the future. Finally, if the decision is made not to formally recognize and control the future costs of social insurance commitments directly in the budget, decision-making could still be enhanced by better integrating supplemental reporting of these costs into the budget process. For instance, the present value of the expected cost of the government's long-term commitments could be tracked in the budget for each budget account or program alongside its cash-based budget authority and outlays. These ideas and others would need to be explored in detail by experts in the field of budgeting to determine their workability and potential benefits. Suggestions have been made that a budget concepts commission is needed to address a number of issues including Social Security; it could be the proper forum to fully develop new budgeting ideas.

Some countries' reform efforts—in particular Australia and New Zealand—emphasized the importance of matching the budget (including the basis of appropriations) with a government's overall performance management and accountability structure.[24] The United States faces similar issues as it strives to satisfy the objectives of recent reforms such as the Government Performance and Results Act (the Results Act).

However, in the U.S. context, the combination of a shift to accrual measurement with a loosening of controls over agency spending decisions raises questions about both decreasing the up-front control and changing the nature of congressional oversight. Nevertheless, some better matching of the cost of resources consumed with the performance achieved might be accomplished without forfeiting budgetary controls. For example, GAO's performance budgeting report suggests that agency budget structures can be brought into closer alignment with their performance goals. This shift would help facilitate greater congressional coordination of performance issues in budget deliberations.

[24]Improved alignment in these countries involved both a change in (1) how costs were measured from cash to accrual and (2) what was measured to focus on the results of government spending.

Ultimately, in certain areas the development of accrual budgeting mechanisms could be used to embrace, not weaken, congressional oversight. In the U.S. system, congressional budgeting could be enhanced if systematic cost data were presented across programs and accounts. To move toward this goal, intermediate steps to provide accrual data while preserving the control benefits of obligation-based budgeting could be taken. For example, mechanisms to charge programs for the use of capital assets over time, such as capital acquisition funds, could better align the cost of capital with its use while preserving up-front control. This type of mechanism is one way that accrual-based costs could be incorporated in the budget at the agency level while preserving the cash and obligations basis for the government as a whole.

In conclusion, the United States can benefit from the experiences of countries that have adopted accrual budgeting. However, for several reasons, the wholesale adoption of accrual budgeting in the United States may not garner the benefits cited by other countries and may in fact undermine other important budgetary goals in the U.S. system. Nevertheless, the United States' obligation- and cash-based budget might be improved by selectively incorporating some accrual concepts when doing so would improve the up-front recognition of the government's commitments. In addition, an exploration of accrual concepts different from those embodied in accounting standards could very well lead to new ways of budgeting for long-term commitments like social insurance. For example, as mentioned above, steps such as deferring revenue recognition could be used as a means to better match Social Security revenues with benefit payments. Finally, some case study countries' experiences point to the importance and challenges associated with improving cost information to support more performance-focused management. As the United States pursues the objectives of the Results Act, continued efforts will be necessary to integrate improved financial and performance information into the budget process.

However, in considering potential reforms, it is important to recognize that the timing of cost recognition—i.e., cash versus accrual measurement—is but one of several factors that shape the budgetary information and incentives provided to decisionmakers. For example, as noted above, the structure or scope of budget accounts—i.e., whether budget costs are arranged based on organization, program, or spending item—also helps determine the level of oversight and control placed on public spending. Both the early experiences of some case study countries and GAO's past work on the Results Act draw attention to the importance of better

integrating planning and budgeting. Significant challenges remain in improving the information provided in the federal budget so that decisionmakers have a more comprehensive and cohesive picture of the government's activities. For example, in the past, GAO has emphasized the need to better integrate information on the various federal strategies and tools—such as spending, tax expenditures, and regulation—being used to address particular national needs. The development of a broader and more integrated budgetary framework is particularly important for crosscutting areas, such as health care or the antiterrorism effort, which may involve tax incentives and/or an array of programs carried out by numerous different agencies. More fully integrating longer-term analyses, such as the use of net present value calculations, into the budget process may also be useful in helping decisionmakers understand the future implications of current policy decisions. Along these lines, case study countries' experiences suggest that there may be value in using multiple measures to assess fiscal and managerial performance. Thus, as in the case study countries, accrual budgeting represents one tool which can be used to improve the role of the budget in addressing concerns about public sector performance, sustainability of government activities, and accountability for results. Further, since the U.S. government continues to have responsibility for the national fiscal policy and management of the national debt, whatever the merits of accrual measurement, budget measures which are easily reconciled with the public sector borrowing requirement will continue to be important.

Matters for Congressional Consideration

As the Congress considers changes in the budget structure and/or process, it would be well served to explore ways to improve information on two dimensions: breadth and time horizon. This report dealt with one way to lengthen the time horizon for information. The Congress should consider the selective use of accrual measurement in the budget in areas where it would enhance obligation-based control. In addition, the Congress and the Office of Management and Budget should consider whether and when to use mechanisms, such as capital acquisition funds, to better match budget recognition with the consumption of resources while preserving up-front control.

Introduction

In recent years, the United States and several other countries have made changes—some more sweeping than others—aimed at improving public sector financial and performance management. Although differences exist, the reforms have converged around the common objective of establishing more business-like practices with the aim of improving the performance, sustainability, and transparency of government activities and ensuring accountability for results. In a number of countries, these reform efforts have challenged traditional thinking about cash-based accounting and budgeting systems and stimulated interest in the potential for accrual-based information to contribute to improved public sector management. Accrual measurement is generally viewed as a better means of matching cost recognition with the consumption of resources.

At least 11 of 29 Organization for Economic Cooperation and Development (OECD) member countries, including the United States, have incorporated accrual-based measures to some degree into their financial management systems, and four—Australia, New Zealand, Iceland, and the United Kingdom[1]—have extended or plan to extend the use of accruals directly into the budget for most items. Others, such as the United States, Canada, and the Netherlands, have adopted more limited accrual budgeting approaches, applying accrual budgeting to a limited number of budget items or specific departments. Other countries' early experiences with accrual budgeting may be useful to the United States as it continues down the path toward improving the way the government budgets for and manages its operations and programs and considers whether to extend its use of accrual budgeting.

[1]As discussed in more detail in the report, Iceland has adopted accrual budgeting with the notable exception of capital spending. The United Kingdom does not accrue revenues.

Background

Method of Budget Reporting Reflects Choices About the Uses and Functions of the Budget

The U.S. federal budget serves as the primary financial plan of the federal government and thus plays a critical role in the decision-making process. Policymakers, managers, and the American people rely on it to frame their understanding of significant choices about the role of the government and to provide them with information to make decisions about individual programs and overall fiscal policy. While budgetary decisions are inherently based on political choice, the method of budget reporting[2] plays an important role by shaping difficult choices and highlighting what trade-offs are brought to the forefront. Further, because the budget process serves as a key point of accountability between policymakers and managers, the way costs are measured and reported in the budget can have significant consequences for managerial incentives. The three bases of measurement discussed in this report—cash, obligations, and accrual—represent much more than technical means of cost measurement; they reflect fundamental choices about the uses and functions of the budget.

Cash and accrual represent two different bases for measuring budgetary costs. Cash-based measurement records receipts and outlays when cash is received or paid, without regard to when the activity occurs that results in revenue being earned, resources being consumed, or liabilities increased. Accrual-based measurement, on the other hand, records revenues and expenses in the period the activity generating revenues, increasing liabilities or consuming resources occurs, regardless of when associated cash is actually received or paid. Accrual measurement is useful in accommodating situations where transactions are not completed in one period. In the financial accounting context, accrual measurement places an emphasis on contractual duties. For example, revenues are recognized to the extent that goods or services have been delivered and expenses are recognized for assets used and liabilities incurred in generating the revenue. In an accrual accounting system, a corollary of revenue and expense recognition is the simultaneous recognition of changes in assets and liabilities.

[2]In this report, the method of budget reporting refers to the criteria used to determine how and when transactions are recognized and measured in the budget.

In comparison, obligation-based budgeting focuses on the legal obligations entered into during a period regardless of when cash is paid or received and regardless of when resources acquired are to be received or consumed. The obligations basis is used in the United States for controlling federal government obligations and outlays. Obligation-based budgeting involves three stages: (1) the Congress must enact budget authority[3] before government officials may obligate the government to make outlays,[4] (2) government officials commit—obligate—the government to make outlays by entering into legally binding agreements, and (3) outlays are made to liquidate obligations. Obligation-based budgeting, as currently used in the United States, provides an additional level of control over pure cash budgeting by requiring that entities have authority to enter into obligations to make outlays of government funds. Budget authority, obligations, outlays, and receipts are generally measured in cash or cash-equivalent terms.[5] Further, with limited exceptions, the unified budget deficit/surplus—the key focus of the policy debate—is the difference between cash receipts and cash outlays. As a result, the U.S. budget is often referred to as cash-based as well as obligation-based.

In contrast to cash- and obligation-based budgeting, accrual budgeting generally involves aligning budget recognition with the period in which resources are consumed or liabilities increased, rather than when obligations are made or cash flows occur. Although accruals can be measured in a variety of ways, the term accrual budgeting typically has been used in case study countries to refer to the recording of budgetary costs based on financial accounting standards. Thus, accrual-based appropriations, by reflecting costs incurred during a fiscal year, generally provide information similar to that found in a private sector operating statement. Table 1 provides an overview of the three methods of budget

[3]In the U.S. federal budget system, budget authority refers to authority provided by law to enter into financial obligations that will result in immediate or future outlays of government funds.

[4]In the U.S. federal budget system, outlays refer to the disbursement of government funds in order to liquidate an obligation.

[5]Theoretically, transactions within an obligation-based budget could be measured on either a cash/cash-equivalent basis or an accrual basis. With limited exceptions, the U.S. obligation-based budget measures transactions on a cash or cash-equivalent basis. One exception is the treatment of credit programs for which budget authority, obligations, and outlays are measured on an accrual basis. Certain interest payments are also measured on an accrual basis. For more details, see the discussion of credit reform in the following section on recent reform efforts in the United States.

reporting—cash-based, obligation-based, and accrual-based—and uses two hypothetical transactions to illustrate how the budgetary information provided to decisionmakers may differ based on the method used.

Choices about the appropriate method of budget reporting are complicated by the multiplicity of the budget's uses and users. The federal budget is simultaneously asked to provide full information and appropriate incentives for resource allocation, control over cash, recognition of future commitments,[6] and the monitoring of performance. Given the multiple and potentially competing objectives, choices about the method of budget reporting involve trade-offs. For example, control over spending is greatest if the budget recognizes the complete cost at the time the decision is made while assessing performance and its cost is generally best supported by recognizing resources as they are used to produce goods and services. As demonstrated in table 1, the up-front funding requirement under an obligation-based budget helps ensure control over the acquisition of a new building but does not align its cost with its use. Conversely, accrual budgeting better aligns the cost of the building with the periods that benefit from its use, but in its simplest form it does not provide for up-front control over entering a legally binding commitment to purchase the building. Given these trade-offs, a budget reporting approach should be selected based on the primary decision-making and accountability needs of a governmental system while balancing the needs of multiple users.

[6]In this report, the term "commitment" is used to mean a promise to provide a good or service. It does not necessarily mean a legally binding obligation, although it may be, in the case of a contract to purchase an asset, for example.

Table 1: Comparison of Methods of Budget Reporting

Method	General description	Budgetary treatment of hypothetical transactions relating to capital and inventories	
		Purchase and 1st year's use of building	**Purchase and use of supplies**
		Total equipment cost = **$10m** Cash payments during fiscal year = **$5m** Depreciation expense for fiscal year = **$1m**	Total supplies ordered and received = **$3m** Total payments for supplies = **$2m** Total supplies used = **$1m**
Cash	Budget authority[a] would equal estimated cash payments for the fiscal year. No appropriation required for outstanding contract costs or depreciation expense. Prior legislative budget approval may not be required before entering into legally binding contracts whose cash consequences do not occur during the fiscal year. Outlays[b] and receipts are recognized in the budget only in year cash flows take place.	**$5m** included in budget authority **$5m** included in outlays and in deficit/surplus calculation	**$2m** included in budget authority **$2m** included in outlays and in deficit/surplus calculation
Accrual[c]	Budget authority is the estimated amount of resources consumed, irrespective of when commitment is made or cash flows take place. Outlays/receipts are recognized in budget in the period resources are consumed, liabilities increased, or receipts earned.	**$1m** included in budget authority **$1m** included in outlays in the deficit/surplus calculation (assuming net operating amount used as measure of deficit/surplus) **$5m** included in financing requirement (cash flows), which may or may not require approval depending on approach used	**$1m** included in budget authority **$1m** included in outlays and in deficit/surplus calculation to cover supplies consumed during the period **$2m** included in financing requirement (cash flows), which may or may not require approval depending on approach used
Current United States obligation-based budget	Budget authority is the authority provided by law to enter into financial obligations that will result in immediate or future outlays involving federal government funds. This authority is required before officials can enter into legal commitments on behalf of the government. Obligations are recorded primarily when goods and services are ordered, regardless of when resources acquired are to be received or consumed.	**$10m** included in budget authority and obligations **$5m** included in outlays and in deficit/surplus calculation	**$3m** included in budget authority and obligations **$2m** included in outlays and in deficit/surplus calculation

Notes:

[a]In this table, the term "budget authority" is used as a proxy for whatever term a government uses to imply legislative approval of amounts in its budget. In case study countries, authority to enter

obligations is generally dealt with through executive controls. In the United States, congressional approval is required to enter into financial obligations.

[b]In this table, the term "outlay" is used as a proxy for whatever term a government uses to signify the use of resources.

[c]As will be discussed in detail in the report, accrual budgeting approaches vary significantly across countries. These examples are to provide general understanding of the accrual budgeting concept in its simplest form.

Cash-Based Measurement Traditionally Used for Public Sector Budgeting

Historically, countries have maintained central government budgets on a cash basis. The use of cash-based measurement in public sector budgeting has several advantages. Perhaps most notably, cash is a widely used and traditionally accepted measure of the government's impact on the economy since the cash-based deficit closely approximates the government's borrowing needs.[7] Further, because it can be easily tracked, cash fits well with the traditional focus of public sector budgeting on control and on ensuring compliance with spending limits. In addition, for most government activities, such as salaries or grant payments, the time between the occurrence of the underlying transaction and the cash flows is relatively short. Therefore, cash-based measurement generally provides both adequate information and control.

There are some activities, however, for which cash measurement is misleading. For programs such as credit, pensions, other postemployment benefits, and insurance, the current-year government obligations can involve cash flows to and from the government for many years. Other programs involve implied commitments or claims on future budgetary resources for social insurance programs such as Social Security and Medicare. Cash-based reporting also does not adequately reflect the cost of other decisions that can have a long-term impact, such as the cost of some tax expenditures, regulations, or government liabilities for environmental cleanup. As a result, cash-based measurement may not recognize the

[7]A cash-based budget is not the only measure available to assess the impact of government activities on the economy. In the United States, for example, the official national income and product accounts (NIPAs) provide a picture of government activities in terms of production, distribution, and use of output. There are a number of major differences in the treatment of federal receipts and expenditures in the NIPAs from their treatment in the unified budget, including adjustments for timing of payments. For example, the unified budget counts receipts for corporate taxes when they are received, whereas NIPA counts them when the liability is accrued. NIPA and the unified budget also differ in their treatment of investment and capital consumption. The unified budget reflects all expenditures of the federal government including investment while the NIPA budget shows current expenditures and thus excludes investments and includes the consumption of fixed capital (depreciation).

government's ultimate costs at the time the commitment is made. In other cases, such as for capital assets and inventories, the actual use or consumption of the asset may be spread over a period of time. As a result, cash-based measurement may not properly align costs with the provision of government goods or services. Thus, the true cost to the government as a whole and the specific cost of particular goods or services may be overstated in some periods and understated in others. These issues have led analysts and researchers in the United States and other countries to raise concerns over the past several decades that cash-based budgeting does not provide adequate information or appropriate incentives for some government activities. While the United States budgeted on an obligations basis and garnered its control benefits, most other case study countries were budgeting solely on a cash basis prior to their shift to accrual budgeting.

Public Management Reforms Have Renewed Interest in Accrual Reporting and Budgeting

In recent years, public sector reforms emphasizing improving transparency, cost effectiveness, and managerial flexibility have served to further highlight the limitations of cash-based reporting and budgeting. For example, it has been recognized that adequately assessing performance under more result-oriented management systems requires information beyond the cash flows in a given period and more consistent and credible cost data across programs and accounts. At the same time, there has been a growing recognition that information on the long-term cost consequences of today's commitments is important for policymakers as they consider making those commitments.

Faced with concerns about the sustainability of government activities and the demands of more result-oriented management systems, some countries have begun moving towards accrual-based measurement for financial reporting and, in some cases, budgeting. To date, at least 11 OECD countries, including the United States, had incorporated accrual measures to some degree for financial accounting purposes, and four—New Zealand, Australia, Iceland, and the United Kingdom—had extended or plan to extend accruals directly into their budgets for most budget items. Other countries, such as the United States, Canada, and the Netherlands, have adopted accrual budgeting approaches only for specific budget items or departments. Table 2 provides a snapshot of the use of accrual reporting and budgeting by the United States and the other countries included in our review.

Table 2: Use of Accrual Reporting and Budgeting by Country Reviewed

	Accrual financial statements		Budgets on accrual basis
	Department-level	National (core) government	
United States	Yes	Yes, subject to audit since FY 1997	No, with limited exceptions[a]
New Zealand	Yes, since FY 1991-92	Yes, since FY1991-92	Yes, since FY 1994-95
Australia	Yes, since FY 1995-96	Yes, since FY 1997-98	Yes, since FY 1999-2000
United Kingdom	Yes, started in 1993; all by FY 1999-2000	Yes, estimated for FY 1999-2000[b]	Proposed. First accrual budget to be presented for FY 2001-02
Iceland	Yes, since FY 1992	Yes, since FY 1992	Yes, since FY 1998. Also presented on cash basis
Canada	No[c]	Yes, modified accrual; full accrual for FY 2001-02	No, modified accrual including pensions and accounts payable
Netherlands	No, except for select agencies[d]	No	No, except for select agencies

Notes:

[a]Accrual measurement used for credit programs and some interest.

[b]This involves the whole-of-government, including local authorities proposed for FY 2005-06.

[c]Departmental financial statements will be produced on a full accrual basis in FY 2001-02.

[d]Twenty-two agencies produce accrual-based financial statements and receive appropriations for the "price" of outputs based on accrued costs. For more information on these agencies and the Dutch approach to accrual budgeting, see appendix IV.

Recent U.S. Reform Has Taken Significant Steps to Improve Financial and Performance Management

Like many of its OECD counterparts, the United States has taken significant steps in recent years to improve public sector financial and performance management. Recognizing the need to improve effectiveness while at the same time limiting costs, the Congress established a statutory framework, outlined in table 3, which provides a powerful framework for instilling a more performance-driven approach to management and accountability.[8] These reforms have served to highlight the need for more complete and reliable cost and performance information. In doing so, questions have been raised about whether the current U.S. cash- and obligation-based budget provides (1) a complete picture of the government's financial condition to assess the long-term sustainability of government activities such as Social Security and (2) matches cost to

[8]See *Managing for Results: The Statutory Framework for Performance-Based Management and Accountability* (GAO/GGD/AIMD-98-52, January 28, 1998).

government performance in ways which effectively support management reform efforts.

Table 3: Statutory Framework[a] for Performance-Based Management and Accountability Reform Efforts in the United States

Title of act	Purpose
Government Performance and Results Act of 1993, P.L. 103-62	The purposes of the Results Act include holding federal agencies accountable for achieving program results and requiring federal agencies to clarify their missions, set program goals, and measure performance toward achieving those goals.
Chief Financial Officers Act of 1990, P.L. 101-576, and Government Management Reform Act of 1994, P.L. 103-356	The objective of the Chief Financial Officers (CFO) Act is to greatly improve and strengthen financial management and accountability in the federal government. The Government Management Reform Act expanded the CFO Act by, among other things, establishing requirements for the preparation and audit of 24 agencywide financial statements beginning with fiscal year 1996 and for the preparation and audit of consolidated financial statements for the federal government beginning with fiscal year 1997.
Federal Financial Management Improvement Act of 1996, P.L. 104-208, Div. A, Title I, sec. 101(f) [Title VIII], 110 Stat. 3009-389	The purpose of the Federal Financial Management Improvement Act is to ensure that agency financial management systems comply with federal financial management system requirements, applicable federal accounting standards, and the *U.S. Government Standard General Ledger*[b] in order to provide uniform, reliable, and more useful financial information.
Clinger-Cohen Act of 1996, P.L. 104-208	The purpose of the Clinger-Cohen Act[c] is to improve the productivity, efficiency, and effectiveness of federal programs through the improved acquisition, use, and disposal of information technology resources.
Federal Managers' Financial Integrity Act of 1982, P.L. 97-255, 31 U.S.C. secs. 1105, 1113, and 3512	The purpose of the Federal Managers' Financial Integrity Act is to establish a framework for ongoing evaluations of agency systems for internal accounting and administrative control.
Federal Credit Reform Act of 1990, as amended, P.L. 101-508, 104 Stat. 1388-609 (1990), and as amended by P.L. 105-33, 111 Stat. 692 (1997)	The purpose of the Federal Credit Reform Act is to accurately measure the costs of federal credit programs by placing the cost of credit programs on a budgetary basis equivalent to other federal spending and to improve the allocation of resources among credit programs and between credit and other spending programs.

Notes:

[a]The framework also includes: Paperwork Reduction Act of 1995, P.L. 104-13; Debt Collection Act of 1982, as amended, P.L. 97-365; Debt Collection Improvement Act of 1996, P.L. 104-134, sec. 31001; Prompt Payment Act P.L. 97-177, 96 Stat. 85 (1982), Codified at 31 U.S.C. secs. 3901-3906; Inspector General Act, as amended P.L. 95-452; and Computer Security Act of 1987, as amended, P.L. 100-235, 101 Stat. 1724 (1988), as amended by P.L. 104-106, 110 Stat. 701 (1996).

[b]The *U.S. Government Standard General Ledger* provides a standard chart of accounts and standardized transactions that agencies are to use in all their financial systems.

[c]The Omnibus Consolidated Appropriations Act of 1997 (P.L. 104-208) renamed both the Federal Acquisition Reform Act of 1996 (P.L. 104-106, Div. D) and the Information Technology Management Reform Act of 1996 (P.L. 104-106, Div. E) as the "Clinger-Cohen Act of 1996."

At the heart of this framework are two significant reforms of the 1990s: the Chief Financial Officers (CFO) Act of 1990 and the Government Performance and Results Act of 1993 (the Results Act). The CFO Act—as expanded by the Government Management Reform Act of 1994 and amended by the Federal Financial Management Improvement Act of 1996—was designed to remedy decades of serious neglect in federal financial management by establishing chief financial officers across the government and requiring the preparation of audited annual financial statements. It requires the preparation and audit of agencywide financial statements for 24 specified agencies beginning with fiscal year 1996 and for the preparation and audit of consolidated financial statements for the federal government beginning with fiscal year 1997. While the CFO Act established the foundation for improving management and financial accountability among agencies, the Results Act aims more directly at improving program performance. Under the Results Act, agencies are required to set multiyear strategic goals and corresponding annual goals, measure performance toward achievement of those goals, and report on their progress.

These reform objectives have been supported by the development of financial and cost accounting standards suitable for the federal environment.[9] Under these federal financial accounting standards, the financial statements required by the CFO Act are prepared on an accrual basis unless otherwise noted. In contrast, the federal budget is based on budgetary concepts and policies adopted by the Congress and the executive branch, generally on an annual cash and obligation basis.

The United States has, however, also recognized the contribution accrual-based measurement can make to budgeting. In a series of reports in the 1980s on managing the cost of government, we advocated the use of some accrual cost measures in the budget. Specifically, we reported that the budget's exclusive focus on cash transactions meant that the costs of some

[9]The Federal Accounting Standards Advisory Board (FASAB) was established in October 1990 to consider and recommend accounting standards to address the financial and budgetary information needs of the Congress, executive agencies, and other users of federal financial information. When the Board has developed a proposed concept or standard, it is submitted to the Secretary of the Treasury, the Director of OMB, and the Comptroller General for their review. If, within 90 days after its submission, any one of these officials objects to the proposed concept or standard, then it is returned to the Board for further consideration. If, within 90 days after its submission, none of these officials objects to the proposed concept or standard, it becomes final. Cost accounting standards developed by FASAB require agencies to develop and implement cost accounting systems that can be used to relate the full costs of various programs and activities to performance outputs.

programs, including retirement, insurance, and credit, were not accurately reflected in the budget. Since then, the budget has been modified gradually with the use of accrual measures to recognize the government's costs for certain programs. For example, in 1985, budgeting for military retirement costs was moved to an accrual basis at the program level by reflecting the government's expected costs for retirement benefits as they are earned. Similarly, since 1987, accruing retirement costs not covered by employee contributions have been charged to employing agencies for civilian employees covered by the Federal Employees Retirement System. In both cases, these program costs are offset within the budget because each agency's outlays for the accrued cost are paid to and recorded as receipts by the military and civilian retirement systems, respectively. As a result, the allocation of costs across agencies is improved. However, because the retirement systems themselves are within the budget, total outlays, and thus the deficit/surplus, include only cash outlays to current retirees.

More recently, the Federal Credit Reform Act of 1990 changed the method of controlling and accounting for credit programs to an accrual basis and uses these accrued costs in the deficit and surplus. Prior to credit reform, outlays for credit programs were reflected in the budget only when cash was disbursed. Thus, the full amount of direct loans was reported as an outlay, ignoring that many would in fact be repaid. For loan guarantees, no outlays were reported when guarantees were made, thus ignoring the fact that some of the guaranteed loans would eventually default and require governmental cash outlays. Cash-based measurement thus overstated the cost of direct loans and understated the cost of loan guarantees in the year they were made. This not only skewed the cost comparisons between these two similar programs but also misrepresented their relative costs in comparison with other federal spending and led to disadvantageous patterns of funding loan guarantees rather than direct loan programs. Credit reform addressed the shortfalls of cash-based budget measurement for credit programs by requiring the budget to include before the credit is extended the estimated net present value[10] of the cost[11] to the federal government over the entire lives of loans or loan guarantees.

[10]Present value is the worth of a future stream of returns or costs in terms of money paid today. A dollar today is worth more than a dollar at some date in the future because today's dollar could be invested and earn interest in the interim.

[11]Under the Federal Credit Reform Act, the estimated cost of a direct loan or loan guarantee is now the sum of all expected costs—including interest rate subsidies and estimated default losses—and all expected payments received by the government over the life of the commitment, discounted by the interest rate on Treasury securities of similar maturity to the loan or guarantee. Reestimation of the cost of loans disbursed or guaranteed in a given year is required over the life of the commitment.

There has been continued interest in the potential for accrual-based measurement to overcome the limitations of cash-based measurement for specific programs. Several years ago, the Chairman of the House Committee on the Budget asked us to review the budget treatment of federal insurance programs to assess whether cash-based budgeting provides complete information and whether accrual-based information could be used to improve budgeting for these programs. In 1997, we concluded that for federal insurance programs cash-based measurement may provide incomplete or misleading information because the annual net cash flows currently reported in the budget may not adequately match premium collections with the expected costs of insurance commitments. We recommended that the Director of the Office of Management and Budget (OMB) develop accrual-based cost estimation models for federal insurance programs and encourage similar efforts at agencies with insurance programs. Further, we recommended that, as estimates become available, they should be reported annually in a standardized format as supplemental information along with the cash-based estimates.[12] Building on these recommendations, legislation was introduced in the 106th Congress calling for the development of accrual-based cost estimates for federal insurance programs, with the eventual aim of incorporating these estimates into the budget. In addition, there has been increasing attention paid to the solvency of the Social Security program, which has generated interest in whether accrual-based information could serve to highlight long-term issues in the annual budget process.

Two concerns in particular have prompted interest in the use of accrual budgeting: (1) a desire to improve the budget treatment of commitments which extend over many years and (2) a growing recognition that to be most useful the improved cost and performance information provided by recent reforms must be closely linked to the federal government's budget and appropriations process. As a result, there has been interest in what lessons may be learned from other countries that have chosen to adopt accrual-based budgeting. These countries' early experiences with the benefits, problems, and feasibility of incorporating accrual-based measurement into the budget may provide insights as the United States continues its own financial and performance management reform efforts.

[12] *See Budget Issues: Budgeting for Federal Insurance Programs* (GAO-AIMD-97-16, September 30, 1997).

Countries Face Common Reform Objectives But Different Institutional Frameworks

Although commonalties in recent public sector reform agendas pursued by the United States and other countries provide a valuable opportunity for shared learning, consideration must be given to significant differences that exist among countries. Specifically, key differences exist between the role legislative bodies in a parliamentary system of government and the Congress of the United States play in the budget process. In the United States, the legislature and executive are independently elected and have different constituencies and roles. In a parliamentary system, governments are formed by the political party, or coalition of parties, that have the support of a majority of Parliament. As a result, the line between the executive and the legislative functions is not as clear as it is in the United States. Many important budget decisions that are debated during the annual appropriations process in the United States occur before the budget is presented for parliamentary approval in the parliamentary system. Parliament's duty is to satisfy itself on behalf of its constituency that the current government has the Parliament's full confidence to continue governing. In fulfilling this duty, case study countries' parliaments regularly enact the government's budget without amendment. In Westminster systems a failure to do so may be viewed as a lack of confidence in the government and signal a need for new elections, including for a new Parliament.

Another difference between the United States and other countries is the method of budget reporting to which accrual is compared. While most of the countries in our study previously had budgeted on a cash basis, the United States has an obligation-based budget that permits greater legislative control than a cash-based budget. This difference is significant for evaluating the implications of a shift to accrual budgeting. As discussed later in this report, the use of an obligation-based budget provides additional recognition and control beyond that in either a pure cash budget or an accrual budget and thus has additional implications for assessing what would be gained and/or lost were the United States to move to accrual budgeting.

Objectives, Scope, and Methodology

Representative Benjamin L. Cardin asked us to review other countries' experiences with accrual budgeting. Specifically, Representative Cardin was interested in accrual budgeting since such a shift in measurement is one way to improve the recognition of the costs of some government commitments. We were asked to review (1) how accrual budgeting fits into these countries' other reform efforts and (2) the implications the shift in

budget reporting has had, or may have, on fiscal policy decision-making and on managerial decision-making. Finally, Representative Cardin asked us to summarize, based on the experiences of these countries, any issues for the United States to consider.

To select countries for our review we consulted with OECD's Public Management Service (PUMA). PUMA analyzes and assesses information and reports on public management developments in OECD member countries, including detailed studies on budget reforms. Based on this preliminary research, we identified countries that have adopted or plan to adopt accrual budgeting for most government activities. These were the United Kingdom, Iceland, Australia, and New Zealand. Two other countries—Canada and the Netherlands—have adopted accrual budgeting selectively and may expand into other areas but do not have set plans and time frames for doing so. In addition, we interviewed PUMA officials, as well as other international experts on accrual budgeting reforms with the International Monetary Fund (IMF) and the Brookings Institution to obtain more information on the nature and scope of these countries' reforms. We also researched these countries' budget processes and reforms from other publicly available information sources, including their own government Internet web sites.

We focused most of our attention on the four countries that have implemented, or plan to implement, accrual budgeting most fully. To obtain information on the genesis of these countries' reforms, the role accrual budgeting plays in broader reform efforts, the perceived benefits of accrual budgeting, and the implementation challenges posed by the shift to accrual budgeting, we interviewed various government officials and other analysts involved in influencing decisions about accrual budgeting. Specifically, we spoke with senior officials responsible for designing and implementing the reforms. In general, these same officials were also able to describe the key details of the new budget format and the implications this shift had or is expected to have for decision-making.

We also spoke with proponents and skeptics of accrual budgeting in Canada and the Netherlands, both of which are considering accrual budgeting issues. In these countries we focused our resources on understanding the issues in their debate over how accrual budgeting might be implemented and how it might influence decision-making.

To determine the interaction between the new accrual-based budgets and fiscal policy, we interviewed senior government officials responsible for

the development of fiscal policy. We also reviewed these countries' published strategies for debt management and fiscal policy to gain an understanding of how accrual budgeting will affect these strategies.

To determine the impact the shift to accrual budgeting will have on resource allocation decisions we met with Members of Parliament when possible and with key parliamentary staff. They were able to describe Parliament's role in the resource allocation process, which differs from the role the Congress plays in resource allocation in the United States. In most of these countries, we also interviewed senior staff to Cabinet officials to gain information on how the accrual information is used in the development and implementation of fiscal policy.

To gain an understanding of (1) how accrual budgeting will influence managerial decision-making at the departmental level and (2) what challenges are faced in implementing the shift to an accrual budget, we interviewed the budget development officers in various ministries. For example, in Australia we met with the budget development officers at the Ministry of Defence and Ministry of Family and Community Services. In the United Kingdom, we met with officials from the Ministry of Defence, Customs and Excise, and the Home Office.

To identify potential audit and financial control issues, we interviewed senior staff in the national audit offices.

We sent copies of the appendixes for review and comment to officials in each of the countries we visited to ensure the accuracy of our portrayal of their reform efforts and the details of the treatment of specific budget items.

To help us identify and assess the implications that the experiences of these countries may have for the U.S. budget process, we convened a panel of experts including staff from OMB and the Congressional Budget Office. We provided the panelists with information gathered during our visits and held a wide-ranging discussion of the implications for the United States. In addition, our panelists and other experts reviewed a draft of this report to ensure completeness and accuracy of the issues discussed in relation to the implications of accrual budgeting in the U.S. context.

Our work was conducted in the six case study countries and Washington, D.C., from July 1998 through January 2000 in accordance with generally accepted government auditing standards.

An Overview of Nations' Accrual Budgeting Initiatives

In the countries we reviewed, the use of accrual budgeting has been linked intrinsically with broader public management reforms driven by concerns about the size, role, and effectiveness of the public sector. While proponents attributed improvements in fiscal policy and managerial decision-making to the adoption of accrual budgeting, others have expressed skepticism about the usefulness and feasibility of accrual measurement for public sector budgeting. Further, because accrual budgeting was just one part of broader reform efforts, it is difficult to isolate the direct benefits and limitations of accrual budgeting from those resulting from other aspects of the comprehensive changes.

Although countries that have chosen to adopt accrual budgeting tend to use a common language in articulating their objectives, they have taken significantly different approaches in designing and implementing their accrual budgeting frameworks. These approaches generally reflect each individual country's reform environment and objectives. Thus, while "accrual budgeting" is often used as a generic term, it has been applied in different forms to address a variety of budgeting challenges.

Accrual Budgeting Adopted as Part of Broader Reform Efforts

Case study countries generally adopted accrual budgeting and reporting as part of broader reform efforts.[1] In general, these efforts sought to improve the effectiveness and efficiency of public sector operations through improved transparency and more decentralized performance-oriented management. However, the impetus for and the magnitude of change varied. Some countries, such as New Zealand and Iceland, were motivated by large deficits and/or concerns over the sustainability of a large public sector. Others, such as the United Kingdom and Australia, undertook change as part of more general improvements in public sector management. Further, the situation is dynamic as some countries continue to refine and expand their reforms, including the role of accrual budgeting.

As countries pursued these broader reform agendas, officials increasingly realized the limitations of purely cash-based budgeting systems. For example, by focusing budget decisions on cash flows within a particular year, cash-based budgeting did not include crucial information on assets, liabilities, and other commitments necessary to assess the sustainability of government activities or to provide incentives for a longer-range policy and

[1]See appendixes for more detailed descriptions of the accrual budgeting reforms in each country.

management focus. Further, because cash-based budgeting did not always capture the full costs incurred in a period, it was viewed as hampering full understanding of and accountability for the relationship between performance and cost, a cornerstone of the performance-oriented management paradigm. According to officials in several countries, these concerns were heightened by the general belief that cash-based budgeting allowed manipulation of spending across years simply by delaying or accelerating cash payments. In addition, they expressed concerns that cash-based budgeting misstated the annual cost of using capital by failing to spread the purchase costs of capital projects over their useful lives and by ignoring the opportunity cost of tying up capital in the form of physical assets.

Proponents described accrual budgeting as an integral tool within broader reform efforts. In New Zealand, accrual budgeting was adopted as a part of a systematic program of sweeping changes that, beginning in 1984, sought to transform the country's economy and public management system in response to several years of serious economic difficulties. These reforms comprehensively and fundamentally restructured the role of the national government in the economy by corporatizing and privatizing government entities and enhancing efficiency and accountability in the remaining public sector.[2] In addition, the reforms radically changed the accountability relationship between the government and departmental executives by establishing 5-year contracts with departmental executives and holding them accountable for achieving discrete and measurable performance outputs included in the terms of purchase agreements[3] signed with their respective ministers. Accrual budgeting was described as an essential tool in supporting this new model of devolution of responsibility by reflecting the full costs of resources used in achieving those outputs.

Australia's adoption of an integrated accrual budgeting and reporting framework built on numerous reforms previously undertaken to improve the effectiveness and efficiency of government operations and increase the transparency of budget and fiscal policy decisions. Following a comprehensive review of the government's operations in 1996, a reform agenda was developed which, according to the National Commission on

[2] *Budget Issues: Privatization/Divestiture Practices in Other Nations* (GAO/AIMD-96-23, December 15, 1995).

[3] The purchase agreements between ministers and departments specify individual outputs in terms and conditions similar to private sector contracts.

Audits, was intended to (1) put the public sector on a more business-like footing, (2) foster a more competitive environment, and (3) build a culture that values high performance. Along these lines, the Financial Management and Accountability Act of 1997 devolved responsibility for financial management to agencies and established mechanisms to help hold chief executives accountable for the results of exercising their management prerogatives. As in New Zealand, some Australian officials described the adoption of an integrated accrual budgeting and reporting framework as key to advancing these efforts. It was generally believed that improving the consistency and comparability of financial, budget, and performance information would increase its use in the decision-making process.

Similarly, the United Kingdom's proposed adoption of accrual budgeting emerged from long-standing efforts aimed at improving public sector performance. Throughout the 1980s the United Kingdom embarked on a series of reforms aimed at improving public sector performance, including the Financial Management Initiative (FMI), which emphasized the devolution of responsibility for budget and financial management. At the beginning of these performance reforms, it became clear that a cash-based system would fail to account completely for all costs necessary to deliver a specific result, thus making it difficult to adequately assess and compare performance within the public sector, and between the public and private sectors. As a result, attention turned to developing an accrual-based integrated system that would better support reform efforts by improving the quality and consistency of the cost information and incentives provided to decisionmakers. Given this, the United Kingdom's accrual-based system was described by one Treasury official as an extension of earlier reform efforts rather than a "new" direction.

Canada also is considering expanding its use of accrual measurement in budgeting as part of an ongoing effort to improve government financial management and establish more business-like practices. The Financial Information Strategy (FIS) first announced in 1989 sought to decentralize many financial reporting responsibilities to departments and to use accrual accounting and new reporting structures to provide departmental managers with better tools for financial management. Through FIS, Canadian officials hope both to achieve improvements in the government's accountability framework and to increase efficiencies in program and service delivery. The Canadian Auditor General opined that efforts to integrate improved financial management into day-to-day decision-making may be impeded if this information is not used for appropriations and budgeting, traditionally the means by which managers are held

accountable. Because of these concerns, in December 1998, the government was asked by Parliament to study how best to incorporate accrual concepts more fully in the budget and appropriations.

Although Iceland's adoption of accrual budgeting also was only one small part of broader reforms, the driving factor in Iceland's decision to adopt accrual-based budgeting and reporting was concern over the sustainability of the government financial commitments. According to senior officials with the Ministry of Finance, the overarching theme behind the reforms was to recognize the full costs of central government obligations when they are made rather than when they are paid. In particular, there were concerns over the large accumulated pension liability for public sector employees. Under the prior cash system, these costs were reflected in the budget when paid, not when earned. As a result, there were concerns that the costs of the government's underlying commitments were understated.

The Netherlands' efforts in this area have focused on rebalancing the role of the public sector through privatization, deregulation, and decentralization. Since 1992, the Netherlands increasingly has adopted performance management initiatives to achieve these objectives and to improve the efficiency of the public sector. The government viewed accrual budgeting and financial statement reporting as providing the framework necessary to manage for results. To date, an accrual framework is being applied only in agencies where it was deemed useful in promoting results-oriented management, such as those engaged in providing specific, definable services like correctional facilities. In 1992, the Netherlands amended its Government Accounts Act to create agencies—a new subunit of government—and allow them to operate on a private sector management model which included accrual budgeting and financial reporting.

Accrual-Based Budgeting Credited with Improving Completeness and Usefulness of Budget Information for Decision-making

The difficulties in isolating the benefits of accrual budgeting from those resulting from other elements in broader reform efforts have not stopped proponents of accrual budgeting from claiming benefits from accrual budgeting. This chapter provides a brief introduction to some of the general benefits and concerns these countries associated with the use of accrual budgeting. The next chapter more fully discusses the role of accrual budgeting in addressing issues of performance, sustainability, and accountability within the public sector.

As outlined in figure 1, proponents credited accrual budgeting with improving the completeness and usefulness of the budget for decision-making by:

- better aligning cost with performance,
- providing information on all costs to encourage a longer-term management and policy focus, and
- improving the consistency and credibility of budget reporting.

Figure 1: Improvements in Budget Information Attributed to Accrual Budgeting

Using generally accepted accounting standards to recognize budget costs in period resources consumed was cited as

➢ Improving the alignment of cost to performance by:

- Better integrating budget information with other financial and performance indicators, including aligning budget recognition with the consumption of capital
- Providing more complete cost information in the budget to ease comparability of operations among both government entities and with the private sector

➢ Providing a long-term balance sheet perspective by:

- Improving budget information on asset and liabilities to assess the sustainability of certain government activities and support longer range policy and management perspective

➢ Improving accountability of government by:

- Increasing the transparency, credibility, and consistency of budget information

Proponents from several countries suggested that accrual-based information was an important tool in understanding the full costs of government programs and activities. Because accrual measurement matches costs with the period resources are used in the provision of goods and services, it generally has been viewed as providing a more accurate and complete picture of the cost of government activities than the cash flows in a given period. For example, accrual budgeting recognizes costs which contribute to the provision of goods and services but do not require immediate cash distributions such as employees' deferred compensation (pensions to be paid in the future). It also spreads the costs of some cash spending over the periods that benefit from it. For example, in an accrual budget, the purchase cost of a capital asset would be spread over the life of the asset as it is used rather than having the full cash amount appearing as a cost in the period the asset is purchased as in a cash-based budget. Thus, accrual-based information is a better indicator of the actual resources consumed in performing government activities. However, whether it is also appropriate for resource allocation depends in part on whether it represents the full cost of government's commitment at the time decisions are made. In some instances, such as pensions, accrual measurement recognizes the government's commitment earlier than obligations measured on a cash-basis; in other instances, particularly capital assets, accrual measurement does not reflect the government's full resource commitment at the time the decision is made.[4]

In addition, accrual budgeting was viewed as enhancing understanding of the cost of performance by making budget information more comparable to other financial and performance indicators. For example, proponents suggested that if both the budget and the financial statement are accrual-based, it is easier to compare the amount requested and appropriated in the budget to actual results reported in the financial statements and other performance reports. Thus, accrual budgeting was viewed as helping to improve understanding of the link between budgeted amounts and results achieved.

[4]Proponents note that case study countries have established compensating control for capital asset projects. Although treatment varies among case study countries, appropriations are generally required for annual cash requirements for asset purchases that exceed departmental reserves or are above a certain dollar amount. See chapter 3 and country appendixes for additional information.

Further, proponents argue that by incorporating a balance sheet perspective,[5] accrual budgeting improves the information and incentives to support a government's stewardship role. While countries that have enacted an accrual budget[6] generally vote on items similar to expenses found in a projected operating statement, in doing so they incorporate balance sheet information into the budget debate. They do this by: (1) including expenses associated with changes in an entity's assets and liabilities in appropriation amounts and (2) requiring primary financial statements to be included as part of the budget presentation.[7]

Accrual-based appropriations generally reflect costs incurred during a fiscal year and thus provide information similar to that found in an operating statement. An operating statement recognizes revenue and expenses of a period and reflects changes in the balance sheet. For example, an asset's value is reduced by depreciation on the balance sheet and a depreciation expense is recorded in the operating statement. Since they reflect information similar to that included in a projected operating statement, appropriations under accrual budgeting generally capture expenses for a period including those that reflect changes in the balance sheet such as depreciation or changes in the liability for pension benefits.

As a result, proponents generally view an accrual-based framework as encouraging a fuller assessment of the government's management of its assets and liabilities, and thus its longer-term financial health. However, it is important to note that none of the countries currently use, or plan to use, accrual budgeting to focus attention on the long-term fiscal pressures of social insurance and health programs that experts predict may have serious implications for many of the world's industrialized countries.[8]

[5]A balance sheet perspective refers to providing information on assets and liabilities of an entity.

[6]New Zealand, Australia, and Iceland.

[7]Primary financial statements include a Balance Sheet, an Operating Statement, and a Cash Flow Statement. Iceland does not require a Balance Sheet in its budget presentation.

[8]Most countries use financial accounting standards as the basis of measurement for accrual budgeting. In order for a future cost to be recognized as a liability under most accounting standards, it must be considered both probable and reasonably estimable. Generally, government commitments such as social insurance have not been judged as meeting these criteria for recognition. Although not considered a liability, U.S. federal accounting standards do call for supplemental disclosures for social insurance programs. For further discussion, see chapter 5.

In these countries, aligning the basis of budgetary measurement with financial reporting standards, in particular, standards that mirror generally accepted practices in the private sector, was seen as increasing the credibility and consistency of budget information for public sector decisionmakers, the financial markets, and the public. Some argued that the public has some familiarity with private sector accounting and so would find a budget based on it more understandable. Using the same measurement basis throughout the financial management cycle was viewed as increasing the credibility and consistency of information provided to decisionmakers and thus enhancing the relevance and usefulness of financial statements and other cost information for budgetary and managerial decision-making.

Proponents acknowledged that accrual-based information could be provided without changing the budget basis, but they suggested it might have little effect on management decisions and behavior unless it was the basis of accountability, i.e., budgeting. Proponents asserted that budgeting on one basis, i.e., cash, and reporting on another basis, i.e., accrual, would send conflicting signals and incentives. In the words of a former New Zealand official who championed the adoption of accrual budgeting, "accrual accounting will not amount to much more than an interesting accounting exercise unless the information is used for the purposes of economic management."

Some Express Skepticism About Use of Accrual-Based Budgeting

Despite these perceived benefits, some officials and other experts expressed skepticism about the value or feasibility of accrual budgeting. Figure 2 lists some concerns raised about accrual budgeting with respect to a central government's role in the economy and control over spending. In addition, a number of implementation challenges raised by accrual budgeting are discussed in chapter 4.

Figure 2: Conceptual Concerns Raised About Accrual Budgeting

Accrual budgeting cited as potentially reducing the completeness and usefulness of budget information by:

- Reducing transparency of information on and attention given to the government's borrowing requirement
- Increasing the need for more sophisticated understanding of financial reporting standards and underlying assumptions
- Reducing accountability for government capital spending commitments
- Increasing complexity, and potentially reducing transparency, while possibly providing better information for only a limited number of budget items

A concern expressed by some experts was that accrual budgeting does not focus sufficient attention on the government's borrowing requirement and thus fails to address adequately the central government's role as partial custodian of the economy. For example, some economists in New Zealand told us that even though the cash flow statement provides information on the government's borrowing requirements, it does not provide adequate information for analyses of the effects of government policies. There was also some concern because decisionmakers have encountered difficulties understanding the complexities involved in the use of accruals for budgeting because of the technical issues and assumptions on which accrual measurement is based. As a result, in Australia and New Zealand, observers suggested that the opportunity may exist for manipulation in the inherently political budget environment. Because accrual measurement focuses on recognizing the financial effects of economic events, it is necessarily dependent on interpretations and judgments about both when those economic effects occur and what their ultimate cost will be. While cash-based budget estimates also require judgment and interpretation, the impact of a budget decision is known with more certainty at the end of the reporting period. In contrast, the impact of accrual-measured budget decisions may remain a matter of judgment. In our previous work on accrual budgeting we have explored the budgetary implications of uncertainty in estimates of risk assumed by federal insurance programs.[9]

Finally, as discussed in chapter 5, using the accrual basis to measure costs in the budget may, in some cases, provide less up-front budget control than does obligation-based budgeting, such as used in the United States. For example, obligation-based budgeting requires budget authority for the full cost of a building before the purchase obligation is made while accrual budgeting generally spreads cost recognition over the life of the building. Thus, for capital assets, obligation-based budgeting provides greater control over committing the government to future payments than does a pure cash or accrual basis. Thus, choices about the basis of budgeting depend in large part on the relative importance one places on recognizing and controlling the full costs at the time decisions are made versus the matching of recognition to the period resources are consumed. As discussed in chapter 5, methods could be developed to capture accrued costs, such as capital acquisition funds, so that costs can be matched with performance while still preserving up-front control.

[9] *Budget Issues: Budgeting for Federal Insurance Programs* (GAO/AIMD-97-16, September 30, 1997).

For these reasons, some view accrual budgeting as potentially undermining the central government's traditional roles in overseeing the economy and ensuring accountability for taxpayer funds. In addition, some U.S. officials and budget experts have suggested that these potential risks of full accrual budgeting may not be warranted given that for most parts of the budget, the differences between cash (for obligations) and accrual measurement are not likely to be significant. Skepticism about the benefits of a change to accrual budgeting is increased by the fact that if accrual budgeting were implemented based on financial accounting standards as done by the case study countries, it would not fully address social insurance commitments.

Countries Vary Significantly in the Design and Implementation of Accrual–Based Budgeting Systems

Despite the use of common language in articulating their objectives, countries that have chosen to adopt accrual budgeting have taken significantly different approaches in designing and implementing accrual budgeting frameworks. Four countries—New Zealand, Australia, Iceland and the United Kingdom[10]—have chosen fairly inclusive approaches to implementing accrual budgeting. These approaches (1) use the same accrual-based[11] accounting standards accepted by the government both for financial reporting and to measure budget items and (2) incorporate primary financial statements[12] roughly similar to those found in private sector financial reporting as part of the budget process. With two notable exceptions—Iceland's exclusion of capital and centralization of pension costs and the United Kingdom's exclusion of revenues—these countries apply accrual-based measurement to virtually all budget items at both the departmental level and the central government. The other two case study countries, Canada and the Netherlands, have applied accrual budgeting on a more limited basis to specific budget items or departments.

[10]Adoption of the United Kingdom's approach remains subject to parliamentary approval.

[11]Some accounting standards are not fully accrual-based. For example, Iceland's accounting standards require that physical assets be reported on a cash basis and the United Kingdom accounts for revenues on a cash basis.

[12]Traditionally primary financial statements include (1) a balance sheet which presents the total balances of assets, liabilities and net position of an organization as of a specific time, (2) a statement of operations which provides information on an organization's flows of revenues and expenses and other changes in the organization's net resources, during a period of time and (3) a statement of cash flows which presents the cash flows of an organization during a period of time.

Not surprisingly, these varied approaches are reflective of each individual country's reform objectives and budgetary needs. As shown in table 4, approaches varied with respect to:

- the extent to which accrual budgeting is used as part of an output budgeting framework in which the budget is intrinsically linked to performance;
- the scope of budget items measured on an accrual basis; and
- the organizational level to which accrual budgeting is applied.

Table 4: Design Features of Case Study Countries' Accrual Budgeting Approaches

Design feature	New Zealand	Australia	United Kingdom	Iceland	Canada (current system)	Netherlands (for select agencies only)
Same accrual-based standards for financial reporting and budgeting	X	X	X	X	X	X
Budget presentation includes primary financial statements	X	X	X	X		
Physical assets on an accrual basis in departmental budgets	X	X	X			X
Accrued pension expense for current employees included in departmental budgets	X	X	X		X	X
Output-based appropriations	X	X				X
Departments receive authority to draw cash for non-cash accruals, such as depreciation, as means of supporting decentralized management framework	X	X				X
Recognition of change in accrued pension liabilities in governmentwide deficit/surplus	X			X	X	
Accrual-based net operating balance used as governmentwide deficit/surplus measure	X			X		

New Zealand and Australia placed significant emphasis on directly linking the budget (including the basis of appropriation) with their overall performance and accountability structure. In these two countries, the shift to accrual measurement occurred concurrently with a shift to output-based appropriations.[13] In general terms, output-based appropriations provide funding for the total resources required to produce an "output" (a good or service produced by departments on behalf of the government) including costs that do not require a cash outlay, such as depreciation and pension expenses. Reflecting the desire for a business-like environment, the intent is that, where possible, appropriations will come to represent the "fair market price" the government intends to pay for the department's outputs. However, Australian officials we spoke with acknowledge that for the first

[13]Both New Zealand and Australia distinguish between items controlled by departments and items administered by departments on the government's behalf such as social insurance. New Zealand has several types of appropriations. For more information, see appendix I and appendix V.

few years, at least, appropriations will be based on the total accrued costs (inputs) used to produce an output. They suggested that the objective over time is to benchmark the prices of these services to the private sector or other government prices for similar services.

The United Kingdom has also proposed an accrual budgeting framework that aligns resources to performance, but it stops short of adopting output-based appropriations. Under its proposed approach, accrual-based "resource accounts" will replace appropriation accounts and become the main form of accountability to Parliament. Parliamentary approval for departmental funding is to operate on a dual cash and "resource" basis. Each budget estimate will be represented by both an accrual request for resources—which includes noncash amounts such as depreciation—and a cash requirement for proposed cash withdrawals. However, in comparison to the New Zealand and Australia models, which provide cash to cover noncash amounts such as depreciation, the United Kingdom's resource budget would treat noncash items as "notional" entries, i.e., departments will not receive cash to cover these amounts. While stressing that a number of issues, such as the precise treatment of capital, were still unresolved, officials noted that a key objective in designing the system was to concentrate attention on resources without relinquishing control over cash.

Iceland's approach to accrual budgeting reflects a greater emphasis on recognizing certain long-term commitments, such as employee pensions, as opposed to allocating costs to particular goods and services. Although significant realignment of the budget occurred as a result of the reforms, its goal was to bring more activities into the fiscal budget—creating links to the decision-making process—rather than aligning resources to programs and activities. For example, Iceland's approach to budget reform differs in two key ways from the approaches adopted in other case study countries: (1) capital is reported on a cash basis as work is completed and paid for, rather than on an accrual basis with depreciation to align its cost with its use in the production of goods and services and (2) public sector pensions are controlled and recognized centrally in the Ministry of Finance's budget rather than allocated to budgets of the various ministries that manage the associated programs and activities. Under Iceland's approach, the main focus of budget debate is on the Operating Statement that includes estimates of revenues and expenses on both an accrual and a cash basis. However, the operating result (deficit/surplus) is reported only on an accrual basis.

Canada and the Netherlands have taken more limited approaches to accrual budgeting, applying accruals only to specific departments or specific budget items. Canada currently uses accrual for public sector employee pensions and accounts payable at both the department level and the governmentwide level. However, it is considering a change which would shift capital and other items to an accrual basis with the intent of better integrating the financial management system. Under the current system, Canada has two measures of fiscal position (deficit/surplus): (1) the financial balance, or cash requirement, which approximates the country's financing need and (2) the budgetary balance—its primary fiscal measure—that includes pensions, accounts payable, and other accrual-measured items even though cash is not needed immediately.

The Netherlands has applied accrual budgeting, using an approach similar to the New Zealand and Australia models, for a select number of agencies (subunits within ministries) but is still undecided about its application governmentwide. Under the Dutch approach, a ministry receives an appropriation to cover the price—including costs for which no cash outlay is required—of goods and services purchased from an agency under its control. For example, the Ministry of Justice would receive a cash appropriation to cover the price of goods and services it intends to purchase from the Prison Service. The Ministry of Justice would in turn give the Prison Service a cash amount that is intended to represent the "price" for the goods and services provided by that agency to the Ministry. Under this regime, Parliament must approve an agency's accrued costs—including noncash costs such as depreciation—and agencies can "save" funds in an account with the Ministry of Finance to fund future capital expenses. In addition, effective January 1, 2000, agencies are able to "borrow" funds from the Ministry of Finance as well. Both the use of "savings" and the "borrowing" of funds require approval by the Ministry of Finance and ultimately must be enacted into law by the Parliament. The governmentwide deficit/surplus is reported on a cash basis.

Each of the case study countries turned to some form of accrual budgeting as part of a broader reform effort. Chapter 3 discusses how they use accrual budgeting to address some key issues.

Perspectives on Accrual Budgeting for Decision-making

As suggested in the previous chapter, the case study countries, to varying degrees, have turned to accrual budgeting to address concerns about public sector performance, sustainability, and accountability. Similar concerns have also been the focus of recent reform efforts within the United States. In several countries, accrual budgeting has been used as a tool to support wider performance management reforms including, in some cases, more decentralized, performance-driven accountability systems. Accrual budgeting is also viewed as improving the recognition of the future costs of current decisions and so increasing the attention paid to the sustainability of government activities. Further, accrual budgeting was viewed as improving accountability by enhancing consistency and transparency of budget information, even though it raises some new control issues. However, the extent to which accrual budgeting has, or is expected to, influence decision-making varies with the approach chosen by each country. This chapter discusses more fully the various perspectives on implications of accrual budgeting for decision-making.

Performance, Sustainability, and Accountability Issues Central to Reform Efforts

The case study countries and the United States share the common objective of improving public sector financial management and performance while enhancing transparency and accountability. As described in the previous chapter, these issues came to the forefront as the countries undertook broader reform efforts to address significant fiscal stress and/or to improve government operations. In the United States, there has been a similar move to improve government performance and financial management, leading to the enactment of a series of reforms.[1] At the same time, changing demographics and other factors have brought to the forefront questions about the sustainability of the government's long-term commitments such as Social Security and Medicare.

To varying degrees countries in our review have used, or plan to use, accrual budgeting to help address similar concerns about public sector performance, sustainability, and accountability. Proponents of accrual budgeting argue that the only way to really affect decision-making is to move beyond financial statement and performance reporting to using accrual information as the basis of resource allocation. However, most countries have limited experience with their accrual-based frameworks and provided only a few specific examples of decisions attributable to its

[1]For further discussion of reform efforts see chapter 1 and chapter 5.

use. Further, since in general case study countries moved from a system of cash-based accounting and cash-based budgeting to accrual accounting and accrual budgeting, it is often difficult to distinguish the benefits of accrual budgeting from those that would have been achieved with accrual accounting alone. This is particularly true for such one-time benefits as the development of financial systems or the identification of assets. Finally, as noted earlier, the comprehensive nature of some of the reform efforts makes it difficult to isolate the benefits of accrual budgeting from those stemming from other changes. For example, New Zealand—the country with the most experience with accrual budgeting—implemented accrual budgeting as only one part of sweeping and radical reforms that restructured the role of government and its financial and performance management system.

Accrual Budgeting as a Tool in Addressing Performance Management Challenges

Country officials and other proponents saw accrual budgeting as a useful, if not critical, tool in addressing performance management challenges. In particular, accrual budgeting has been used to provide more timely recognition of the complete costs of government activities, an important factor in assessing performance. However, the design of each country's accrual budgeting system, which tends to reflect the country's overall management approach, shapes its role in addressing performance challenges.

In our case study countries, accrual budgeting is credited with supporting broader management reform efforts in several ways, such as

- reflecting and supporting more decentralized and performance-focused accountability systems,
- facilitating more competitive, businesslike approaches to providing government goods and services, and
- encouraging more efficient and effective resource management, particularly with respect to capital assets.

Accrual Budgeting Viewed as Supporting More Decentralized, Performance-Focused Accountability Systems

In some countries, accrual budgeting has been used to support more decentralized, performance-focused management. Most notably, in New Zealand and Australia, the adoption of accrual budgeting complemented a shift to systems that allow managers considerable autonomy, including increased freedom over the use of resources (inputs), while holding them accountable for delivering specified results within budgeted costs.[2] Officials and other reformers from both countries stressed that accrual measurement, by providing a tool to match costs with the provision of goods and services, was key to supporting these more decentralized management systems that emphasize managerial flexibility as a means of improving efficiency and effectiveness.

In both Australia and New Zealand performance management benefits were attributed to the union of output budgeting[3] and accrual budgeting, not a shift to accrual measurement alone. In general, output-based appropriations provide funding for the total resources used to produce an "output" (a good or service produced on behalf of the government), including costs that do not require an immediate cash outlay. Managers are then given significant discretion over the mix of inputs (spending on salaries, supplies, capital, etc.) used to produce agreed upon outputs. This type of approach reflects and supports the philosophy that the public sector should operate as close to a private sector model as possible.

[2]The Netherlands has applied a similar approach on a more limited basis to specific department activities.

[3]Output generally refers to goods and services produced by departments. For example, in New Zealand the quantity and price of outputs are agreed upon by the ministers and their departments' chief executives.

By structuring appropriations around outputs, these systems are intended to reduce the traditional budget focus on controlling inputs while increasing accountability for performance. Under New Zealand's approach, output-based appropriations are the result of purchase agreements between department executives and their ministers, with the ministers specifying the output to be provided in a given quantity and at a given quality. In Australia, appropriations for each department are for the full financial resources, measured on an accrual basis, required to produce outputs that contribute to the outcomes the government is trying to achieve. This output-outcome structure is determined during a strategic planning process in which departments and their ministers define desired outcomes, then define the outputs that, if delivered, would lead to these outcomes. Reflecting the desire for a more businesslike environment, the ultimate goal in both countries was for departments to be appropriated the fair market price of outputs.[4] Further, to provide additional incentives to continually seek efficiencies, the Australian system permits departments to retain a share of any operating surpluses.

Accrual budgeting was described as useful, if not critical, to developing accountability within these more decentralized, output-focused systems. In the view of one former official from New Zealand "a decentralized public management structure that focuses on output and performance could not be managed without accrual budgeting." Because an output-based system gives departments significant discretion over how funding is used to produce outputs, oversight is premised on the ability of policymakers, as the purchasers of goods and services, to adequately assess the price and quality of outputs. As a result, reliable information on the full costs of producing goods and services, rather than just the immediate cash outlays, becomes increasingly important to ensuring accountability.

By better aligning budget recognition with the consumption of resources, proponents view accrual measurement as providing a better analytical base to assess the full costs associated with a given level of performance. For

[4]New Zealand has used a staged approach to implementing accrual-based output appropriations. The final stage, to which no department has transitioned, assumes competition among suppliers of outputs. For more detailed discussion of the New Zealand system, see appendix V. Australia's system is designed so that appropriations ultimately are to represent the "price" the government intends to pay for each agency's contribution to the achievement of planned outcomes. Australian officials noted however that at least in the first few years, appropriations would be based on the total accrued costs (inputs) used to produce an output. See more information on the Australian system, see appendix I.

example, accrual measurement recognizes costs as they are incurred, such as employee pensions, which may not result in cash outlays for many years but nevertheless were earned within a budget year. Proponents also point out that accrual measurement helps mitigate some cost distortions inherent in cash-based budgeting. For example, the National Commission of Audit in Australia noted that, under its accrual budgeting framework, a department would no longer appear efficient in budgetary terms just because it used less cash in a year if, at the same time, it accumulated more liabilities. Conversely, it noted that a department would not automatically appear as a poor performer because it spent a large amount of cash in 1 year on capital assets that may in fact enable it to operate more efficiently over time. As a result, accrual budgeting is seen as enhancing accountability by, for example, facilitating comparisons of cost and performance among alternative suppliers, both public and private.

Proponents from both New Zealand and Australia stressed the importance of integrating accrual-based information directly into the budget. In their view, better cost information alone would be insufficient to influence managerial behavior; holding decisionmakers and managers accountable through the budget process for all the costs associated with a given level of performance would be more effective in creating incentives to ensure efficiency and effectiveness in the absence of input controls. Along these lines, a former New Zealand official involved with the reforms stressed that if performance is what drives reform, and accrual concepts are deemed most appropriate to assess the costs associated with performance, then it follows that one would budget on this basis.

Accrual Budgeting Viewed as Useful in Facilitating More Competitive Approaches and Fostering Cultural Change

Whether combined with output budgeting or not, accrual budgeting was described as improving performance by fostering more competitive and businesslike approaches within the public sector. For example, accrual budgeting was described as making it easier to compare performance among alternative suppliers, both public and private. In addition, accrual budgeting was described as important to fostering cultural change that heightens awareness of financial and performance management issues.

Accrual Budgeting Viewed as Supporting Performance Reforms by Facilitating Comparisons

Some proponents view accrual budgeting as supporting performance reforms by facilitating more valid comparisons among alternative sources of goods and services. As we have reported in the past, consistent and complete cost information is important to fostering better management by making it easier to more fully understand the implications of different decisions. Similarly, officials and proponents suggested that accrual

measurement allows for more valid comparisons of performance and thus can help the government identify inefficient areas or determine the most efficient method of delivering government goods and services. Further, accrual budgeting was seen as fostering more performance-focused management and oversight by increasing the comparability of prospective budget information with actual financial and performance information.

A senior budget official from the Netherlands used prison services to illustrate the discord between cash-based budgeting and performance assessment, including comparisons among alternative suppliers. He noted that, on a cash basis, a prison making capital improvements would appear more costly in the budget than another prison that is not making such improvements, regardless of the year-to-year relative efficiency of the prisons' operations. In his opinion, accrual budgeting, by spreading the budget recognition of the cost of capital improvements over the life of the asset, would help to improve the information and facilitate more valid comparisons between the relative cost of operations. While this was an improvement over a cash-based budgeting system, it does not provide for the up-front control over capital purchase obligations that exists in an obligation-based system. One possible approach combining the benefits of both would be to compare accrual-based financial reports while retaining control over government commitments under an obligation-based budgeting system.

Proponents of accrual budgeting saw enhanced comparability with the private sector as beneficial. Full consideration of how a good or service can be provided most efficiently requires understanding its full costs including noncash items such as employee benefits earned but paid later. Under cash budgeting or obligation-based budgeting measured on a cash basis, these items tend to be excluded from a government's current budget decisions. However, they are incorporated into the price of private sector suppliers. Proponents envision that accrual budgeting, by providing more complete and comparable costs, could result in better choices about whether a good or service should be provided by a government department or by a private sector entity. New Zealand intended for departments to pay interest, taxes, and dividends so that their costs could be more readily compared to other suppliers (including private sector entities) providing similar goods and services.

With more complete cost information, accrual budgeting is seen by its proponents as a potential tool to encourage competition and facilitate mechanisms such as contracting-out, price benchmarking, and intra-agency

charging. For example, New Zealand used accrual reports to determine the full cost of providing policy advice in various departments. It was also credited with helping to identify high and low cost areas, providing a clearer understanding of intradepartmental cost differentials and raising the possibility of achieving greater efficiencies and cost savings. As discussed above, some proponents see the ability to more readily make comparisons based on complete cost information as an essential component to ensuring accountability within decentralized management systems.

Accrual Budgeting Seen as Important Tool in Supporting "Cultural Change"

Proponents see accrual budgeting as an important tool in changing the public sector "culture" towards a more competitive, businesslike environment. As a general point, proponents argued that providing accrual-based information in financial statements or other supplemental reports was not likely to change behavior significantly if the accountability process, i.e., budgeting, remained on a cash basis. For example, the Australian National Commission of Audit (NCOA) expressed the view that a full accrual framework, including accrual budgeting, was an essential component of the structural and cultural change the government was seeking for a more competitive, efficient, and effective public sector. Observers in the United Kingdom also suggested that, although as a general rule generating interest in financial management issues is difficult, the use of accrual measurement in the budget appears to have increased the attention paid to implementing the recent accrual reforms. Similarly, Canada's Auditor General emphasized the importance of changing the basis of appropriations to accrual to encourage the use of this information in day-to-day management.

Proponents generally held the view that accrual budgeting serves to enhance the prominence of performance management and oversight. Country officials and department managers we spoke with noted a greater focus on financial management as a result of the shift to an integrated accrual-based framework, including accrual budgeting. They suggested that, since the budget really matters to departmental managers, including accrual-based information in the budget greatly increases the stakes associated with its preparation and use. For example, officials from the Office of the Controller and Auditor General in New Zealand said that financial data under the accrual-based framework are more robust, consistent in quality, and timely. Departments now produce monthly accrual reports within 7 days of the end of the month. They attributed this in part to the departments more closely monitoring their accounts on an accrual basis to avoid breaching appropriations. The view that accrual-

based frameworks had improved, or were expected to improve, financial and cost data was held in most case study countries.

Accrual Budgeting Viewed as Encouraging More Efficient and Effective Resource Management

Advocates of accrual budgeting view it as a useful tool to encourage more efficient and effective resource management, particularly with respect to capital assets.[5] However, because most case study countries used predominately cash-based budgeting systems prior to changing to the accrual basis, their views of the trade-offs associated with a shift to accrual budgeting based on financial accounting standards are likely to differ from that of the United States. Shifting to accrual budgeting might not yield the same benefits in the United States, which already has accrual-based financial reporting. Moreover, compared to obligation-based budgeting in the United States accrual budgeting without compensating controls would delay the budget recognition of the government's commitment for asset purchases.

Proponents and officials in most of the case study countries view accrual budgeting as encouraging the more efficient and effective use of resources by

- providing better information and incentives with respect to total resources consumed in the provision of goods and services, and
- better reflecting the cost of capital, thus encouraging better capital asset management.

Proponents see accrual budgeting as improving resource management by providing a better analytical base and incentives for assessing performance and managing costs. Managers from the United Kingdom and New Zealand expected that by providing more and better quality information, accrual-based frameworks would improve resource management by increasing the number and quality of questions asked about an organization and its performance. Although some other government officials view the increased agency discretion provided in systems that combined output budgeting

[5]Not all case study countries use accrual budgeting for capital assets. As discussed in appendix III, Iceland expenses assets as payments are made. Canada plans to report all assets on an accrual basis in its whole-of-government financial statements beginning in fiscal year 2001-2002. As discussed in appendix II, Canada has not decided yet whether to budget on a full accrual basis. In the United Kingdom, the current proposal is for depreciation and capital charges to be "notional entries" which require a parliamentary vote but will not result in the departments receiving cash.

with accrual budgeting with concern, proponents credited these systems with helping achieve fiscal constraint by better targeting spending cuts and, as discussed in the previous section, by encouraging efficiency gains. For example, according to a former New Zealand government official, under the old cash and input focused system, the government could arbitrarily impose an across-the-board budget squeeze but would not necessarily know the direct implications of this squeeze on performance. In contrast, improved availability and quality of performance and cost information under their accrual-based frameworks would enable officials to better understand the implication of budget decisions on performance. Specifically, under accrual-based output budgeting, the ability to translate a change in funding to a change in output was viewed by some proponents as improving the decision-making process. Some we spoke with, however, credited these benefits, at least in part, to the better linking of spending to specific results than to the shift from cash to accrual measurement.

In some countries accrual budgeting was used as a tool to support increased flexibility in asset management. In New Zealand, Australia, and the Netherlands, for example, department appropriations include funding for noncash items such as depreciation expense. Managers are expected to manage their asset base, which includes purchasing replacement assets with funds accumulated from this depreciation expense, although skeptics might worry that such funds would not be saved. Proponents say that this increased flexibility allows managers to make and implement more efficient decisions with respect to their asset mix. In New Zealand, for example, managers could replace nonperforming telephone equipment more quickly rather than submitting to the previous lengthy approval process. In this approach, however, more than budgetary accounting has been changed. Agencies in some countries have been given a level of discretion with respect to asset purchases that is significantly different from the U. S. system.[6]

[6]Proponents point out that case study countries established a number of compensating controls in an attempt to alleviate control concerns. For example, in New Zealand, managers are not allowed to change the structure of their balance sheets without legislative approval; this is aimed at preventing managers from running down their asset bases to artificially lower the price of outputs. A number of case study countries also established supplemental approval processes for capital projects. See country appendixes for additional information.

Up-front control over contractual obligations is the focus of the U.S. obligation-based budget and including the cost of an asset in the budget before the government's commitment is made provides the Congress an opportunity to control spending. Recording the full cost for an asset purchase up front, as in the United States' obligation-based budget, also promotes fiscal control, an important objective in U.S. budgeting. By recording the costs up front, agencies and the Congress are encouraged to compare that cost with expected benefits when deciding whether to purchase the asset. Conversely, for capital assets, accrual measurement would delay cost recognition so as to spread the costs over the life of the asset.[7] In this sense, choices about the basis of budgeting depend in part on the relative importance placed on recognizing and controlling the full costs at the time decisions are made versus the matching of budget recognition to the period resources are consumed.

Officials in several case study countries pointed to some compensating controls within their accrual frameworks. For example, if the cost of an asset exceeds accumulated depreciation, "capital injections"[8] are required and these are subject to parliamentary approval in Australia and New Zealand and parliamentary notification in the Netherlands. In these cases, budget approval would be for the cash required in the budget year. In addition, in New Zealand, even if an agency had accumulated sufficient funds to replace an asset without a capital injection, capital purchases above a specified amount require approval.[9] Further, Australia, New Zealand, and the United Kingdom require additional information on capital purchases under their accrual-based frameworks. For example, information such as (1) depreciation and capital charges resulting from the new asset and (2) the available cash reserves and capital injection needs may be required. This richer suite of information is perceived to help decisionmakers to make the proper trade-off between alternatives, e.g.,

[7]Although treatment varies among case study countries, appropriations are generally required for the annual cash required to purchase assets. However, these annual cash amounts may not represent the full cost of the assets. In some cases, legislative approval is not required for asset purchases below a certain amount if the department can fund them from depreciation reserves.

[8]In general terms, a capital injection refers to the amount of additional funds required for a capital purchase beyond a department's available reserves. It represents an increased investment in a department's asset base.

[9]Asset purchases over NZ$10 million require cabinet approval, whether or not departments need a cash injection.

whether to buy or lease a new asset, or simply to renovate an existing asset. Finally, some proponents pointed out that because depreciation and the capital charge would be included in future budgets, an asset no longer appeared as a "free good" after the initial purchase.

Improved alignment between budget recognition and the use of capital is another cited benefit of accrual budgeting. In Australia, New Zealand, the United Kingdom, and the Netherlands, the appropriation for a department's operating budget or for specified outputs includes the annual cost of using capital, i.e., depreciation and the cost of capital charge.[10] This treatment was viewed as useful in (1) enabling comparisons among the relative costs of different operations and (2) distinguishing between current and capital spending.

Proponents believe that this approach improves decision-making by spreading the budget recognition of capital costs over the life of the asset. Specifically, it was viewed as improving both the information and the incentives to make more valid comparisons between the relative cost of operations. Further, some proponents suggested that by better aligning the budget recognition of capital with its use, accrual budgeting can be used to provide a better distinction between current spending and capital investment. For example, in New Zealand, the United Kingdom, and Australia, cash requirements for capital acquisitions are treated separately from the cost of using capital in departmental budgets. Some proponents stated the view that this reduces a perceived bias against investment which may be created when the purchase cost of a capital asset must be recognized in the budget in the year of the purchase. The trade-off here is between aligning budget recognition of capital with its use and the greater fiscal control realized from up-front budgeting. In the United States, the purchase cost is recorded up front so that commitments for asset purchases can be controlled by the Congress before they are made. In the U.S. setting, information on the use of capital in providing services is available to the Congress in accrual-based financial reports for use in conjunction with obligation-based budgeting.

[10]Specifically, in New Zealand, Australia, and the Netherlands, departments receive cash funding to cover these noncash amounts. In the United Kingdom, the current proposal is for these amounts to be "notional entries" which require a parliamentary vote but will not result in the departments receiving cash.

To further encourage the efficient use of assets, some countries also incorporated capital charges into their accrual budgeting frameworks. A capital charge, similar to an interest charge, generally is used to reflect the opportunity cost of capital invested. Several countries in our review—Australia, New Zealand, and the United Kingdom—have established a policy of levying a capital charge based on a percentage of a department's net assets in order to recognize the cost of capital held by departments.[11] In New Zealand, this works as follows: departments are appropriated as part of the output price a capital charge based on their asset base at the beginning of the year; at the end of the year they must pay the government a capital charge based on their year-end asset base. If a department has a smaller asset base at the end of the year than the asset base for which the appropriation was made, the department is permitted to keep part of the appropriation made for the capital charge. New Zealand officials see this as providing an incentive to identify and dispose of underperforming assets; Department of Education officials stated that the capital charge spurred the department to sell a number of vacant sites that it had acquired in the 1960s and held although they were no longer needed.

Further, proponents credit accrual budgeting with improving the identification and valuation of assets. Although acknowledging that this benefit might have been achieved through a shift to accrual accounting alone without changing the basis of budgeting, proponents suggested that the link to budget improved incentives to take the reforms seriously and not simply treat accrual-based information as a paperwork exercise. Some officials and managers cited cases of finding assets that were poorly managed and even assets that they were unaware of owning. In New Zealand, the asset identification exercise led to the discovery that unpaid fines due to the Department of Justice were a significant asset on the department's balance sheet. Subsequent attention prompted the department to actively manage its accounts receivable by replacing traditional collection methods with direct payment systems at courthouses and using computerized call centers for tracking slow payers.

Some Skepticism and Concerns Raised About Implications of Accrual Budgeting on Resource Management

Some skepticism has been raised about the claims for accrual budgeting's beneficial impact on resource management. Some expressed concerns about the implications of the assumptions and judgments necessary for accrual measurement on transparency and thus on users' understanding. In

[11]In the Netherlands, agencies will pay for the capital costs associated with loans used to finance asset purchases beginning in 2000.

addition, some we spoke with were uncertain about the extent to which the new information had influenced managerial decision-making. Several issues were noted with respect to asset management. For example, officials in New Zealand's Office of Controller and Auditor General were uncertain about the effectiveness of having a charge for capital in changing behavior significantly. Further, some officials noted that, while changes resulting from the shift to accrual were greatest for capital intensive departments, in New Zealand only a limited number of departments hold enough assets to make the change significant in the annual budget process. Along a different line, some analysts expressed the concern that capital charging could drive department executives to decisions that are rational in the short term but damaging in the long term. For example, an audit official suggested that a department might have an incentive to try to operate with obsolete and fully depreciated assets in order to avoid a higher capital charge. In addition, while proponents thought that the increased discretion over asset purchases was key to supporting managerial efficiency and effectiveness, the increased discretion combined with cash funding for depreciation could result in the potential for departments to divert this funding for other purposes.

Additional concerns were raised that some forms of accrual budgeting could impede efficient asset management.[12] For example, some officials in New Zealand noted that in a technology-intensive environment, such as defense, asset prices tend to increase commensurate with improving technology. In such an environment, accumulated depreciation would be inadequate to fund asset replacement, thus requiring capital injections. Because capital injections are given heightened scrutiny during the budget process, some hypothesized that it could be harder to replace assets. Another concern about the New Zealand model of accrual budgeting was the possibility that requiring departments to maintain their asset bases[13] could serve to lock in the asset levels that existed when accrual budgeting was first implemented whether or not this reflects the optimal allocation of assets among departments. Further, the use of initial asset base levels to calculate future budgetary amounts, including the depreciation charge

[12]As noted earlier, some forms of accrual budgeting provide appropriations for noncash expenses such as depreciation with the expectation that departments will use these funds to maintain their asset base.

[13]In an accrual budgeting framework, maintaining the asset base generally refers to managing the value of assets on the balance sheet so that it does not decline from year to year except through the sale of excess assets.

generally based on current value, could give departments that were asset rich an advantage over those that were asset poor. This latter group either must request a capital injection or operate with minimal assets. Although New Zealand officials told us that there had been no significant attempt to optimize asset levels prior to the shift to accrual budgeting, proponents suggested that accrual budgeting has increased the attention given to these issues.

In addition, the need to incorporate accrual measurement directly into the budget may be questioned. Some of the benefits credited to accrual budgeting—improved asset identification and valuation, better information on the organization and its activities, or improved capital investment planning—might have been achieved without a shift in budgetary measurement by, for example, implementing accrual-based accounting and reporting alone. Some experts also noted that the cost of capital charges could be implemented within obligation- or cash-based budgeting systems. Proponents, however, expressed the strong belief that the link to the budget increased the incentives to take the reforms seriously and to ensure numbers were reasonable.

Asset identification and valuation were cumbersome and time-consuming efforts and the integration of accrual concepts such as depreciation created new budgetary control issues. These and other implementation challenges are more fully discussed in chapter 4.

Sustainability of Government Activity Partially Addressed by Accrual Budgeting

Some countries that have incorporated accrual information in their financial management systems have done so, in part, with the expectation that it will help decisionmakers better understand long-term sustainability of government policies. This can be thought of as going beyond the longer-term management perspective for capital or more effectively targeting budget reductions to support fiscal constraints, as discussed in the preceding section, to the question of assessing the sustainability of government policies by providing

- better budget recognition of liabilities, and
- a more complete set of information to assess a country's financial health.

However, there are limits to using an accrual budget based on financial accounting standards in addressing long-term sustainability issues. A key limitation is that accrual budgeting as implemented by the case study

countries does not capture social insurance commitments. The case study countries chose to largely mirror their financial accounting standards in their accrual budgets, but social insurance is not judged to be a liability under their accounting standards. Thus, none of them have budgeted for such commitments on an accrual basis. This would also be the case if the United States adopted accrual budgeting strictly based on its federal accounting standards.

Accrual Budgeting's Better Recognition of Liabilities Credited With Leading to Program Changes

Although accrual budgeting does not deal with social insurance programs, proponents said it provides a fuller picture of other liabilities arising from past and current policy actions. For programs with long-term commitments, including public employee pensions, insurance, and credit, cash-based budgeting may not recognize a government's ultimate costs at the time the commitments are made. In these cases, accrual-based information on the government's liabilities could improve budgetary decision-making. Indeed, proponents from New Zealand and Iceland pointed to accrual budgeting as leading to changes to such programs.

In both countries the adoption of accrual budgeting highlighted issues with respect to public employee pension programs. In Iceland, accrual budgeting showed the consequences of wage negotiations on future public employee pension costs. Since a retiree receives a pension tied to the base salary of the person currently in the retiree's former job, wage renegotiations directly affect Iceland's pension liabilities. The full costs of these agreements were not fully realized by the public until the adoption of accrual budgeting led to the recognition of the liability in the budget estimates. Officials informed us that there is no longer public support for decisions that are so costly in the long term. Similarly, in New Zealand, recognizing pension liabilities on the balance sheet and accruing the annual change in that liability as an expense in the budget prompted greater fiscal caution about these long-term commitments. Under cash budgeting, the magnitude of future public sector pension costs was recalculated and reported to Parliament every 5 years, but this information generally did not play a significant role in the budget debate. According to a former minister, once the full liability for public sector pensions was brought onto the balance sheet and the annual change in the liability was included in the budget as an expense, New Zealand made the difficult decision to close its defined benefit pension plan to new government employees.

As a result of recognizing the liability from providing accident coverage, the New Zealand government initiated efforts to reform the Accident Compensation Corporation (ACC) program. ACC is an insurance program comprising six accounts covering accidents ranging from motor vehicle to those occurring on the job. In the past, the value of future payments due to claimants was recorded only in the financial statement footnotes and had no impact on either the operating statement or balance sheet of either the ACC or the government. The accounting treatment recently changed, and the government recorded a liability for these programs for the first time in fiscal year 1999-2000. Consequently, the government booked on its balance sheet a liability of nearly NZ$7 billion for previous accidents.[14] With accrual budgeting, this also reduced the estimated budget surpluses by NZ$500 million since the estimated future cost of current accidents was booked as an operating expense. Officials attributed New Zealand's decision to raise premiums and add surcharges largely to this inclusion of program costs in the budget. The intention was to fully fund portions of ACC by 2014, thus helping to ensure that those programs are sustainable into the future.

Accrual budgeting was also credited with spurring changes in insurance claims management. Under the new accrual environment, ACC staff is dedicating more time to managing long-term disability cases with the highest projected costs. Through active management, ACC aims to reduce the severity of disability cases and thus program costs in the long run.

[14]The recognition was to be based on the estimated probable cost of claims existing at the end of the year, with minor adjustment for claims incurred but not reported based on historical experience.

Some proponents also believe accrual budgeting helps improve decision-making by providing more complete information for understanding how budgetary decisions will affect a country's financial health. Accrual budgeting frameworks were viewed as providing more complete information in at least two ways. The first way is by including actual and projected accrual-based financial statements in the budget presentation. For example, the accrual budget presentations in Australia, Iceland,[15] New Zealand, and the United Kingdom include the primary financial statements.[16] The second way is by reflecting annual balance sheet changes in the operating statement which is, in effect, the accrual budget. For example, an accrual-based appropriation would include the cost of pension benefits earned but not paid in the budget year, which represents the annual increase in the liability on the balance sheet. As a result, accrual-based appropriations capture changes to a government's net worth,[17] which flow through the operating statement. Some view trends in net worth, if measured on a consistent basis, as one indication of whether a country's fiscal condition is improving or declining.

Some Experts Question Usefulness of Accrual Budgeting for Addressing Sustainability Issues

While proponents expressed the view that accrual budgeting was valuable in heightening awareness of sustainability issues, other experts were more cautious on this point. Two key concerns were:

- some significant government commitments are not captured in an accrual budget, and
- the meaning of "net worth" in the government context is unclear.

First, as noted above, accrual budgeting based on financial accounting standards does not capture some key fiscal pressures, such as future costs associated with social insurance programs. While some case study countries used modeling to estimate the future costs of these programs, none include them—or plan to include them—in the accrual-based budget.

[15]Iceland does not include a projected balance sheet in its budget presentation.

[16]Primary financial statements include an operating statement, a balance sheet, and a statement of cash flows.

[17]Net worth is the difference between balance sheet assets and liabilities. Case study countries that have capitalized assets included values for heritage assets and defense weapon systems as assets on their balance sheets. However, some exceptions are made due to valuation difficulties.

Specifically, none of the case study countries recognize social insurance commitments as liabilities in their financial statements or record the expense in their accrual budgets. This is because these commitments do not meet financial accounting standards' criteria for recognition as a liability. Generally, the financial accounting standards adopted by most of the case study countries define liability recognition with three criteria: (1) an event has occurred, (2) a future payment is probable, and (3) the amount of the future payment is reasonably estimable. Using these standards, a differentiation generally is made between pension and insurance programs, which meet the recognition criteria as liabilities, and social insurance programs, which do not. For example, premium payments for insurance programs bring with them an expectation that claims will be paid—a probable and reasonably estimable future payment will be made once an insured event has occurred. On the other hand, the future payments for social insurance programs, which in the case study countries are funded on a pay-as-you-go basis, could be adjusted to fit within the fiscal policy objectives of the government at the time the payments need to be made.[18] However, many of the case study countries use long-term cash forecasts, as does the United States, to recognize and present information on the imbalance between revenues and expected payment streams for social insurance programs.

Another argument made against recognizing social insurance as a liability is that a key factor in the government's ability to meet these social obligations, i.e., the power to tax, is not recognized as an asset. For example, according to officials in several case study countries, estimating future tax revenue is complicated and it may not be able to be reliably estimated. Since the power to tax is an asset that the government could call upon to meet the demand for social insurance, some experts suggested that accruing a liability for social insurance but not recognizing the power to tax as an asset would give an inaccurate picture of fiscal position.

This is one major reason why some accrual-based concepts such as net worth are difficult to fit into the government context. As mentioned above, some important long-term commitments are not recognized as liabilities and do not appear on the balance sheet. Further, a government's "power to tax"—the means by which any government can pay its long-term

[18]The Canadian Pension Plan, broadly similar to the U.S. Social Security system, is a joint federal-provincial program. It is separate from both federal and provincial budgets and its revenues and expenses are not included in Canada's budget.

commitments—is not recognized in government financial statements. In addition, there are numerous valuation issues created by the unique nature of many government assets and liabilities. Nevertheless, proponents maintain that the new framework provides more and better information than the previous cash-based framework. Further, New Zealand officials suggested that, although there are difficulties in measuring and interpreting some balance sheet items, this information may still provide useful trend information if measured using consistent standards from year to year. That is, while the measure may not necessarily be precise, changes from one year to the next may provide insights to decisionmakers on the implications of their decisions for the overall health of the nation.

Some Accountability and Control Issues Are Addressed by Accrual Budgeting but Others Are Raised

Proponents in all of the case study countries expected greater accountability from the adoption of accrual budgeting. Specifically, officials and other proponents credit the use of accounting standards for budgeting with increasing the transparency and credibility of budget estimates. Against the backdrop of their own budget history, they viewed the adoption of accounting standards as promoting greater accountability and transparency. Markets in particular were viewed as one audience for these reforms; for example, enhancing the credibility of budget information for financial market participants was viewed as a critical part of New Zealand's initiatives to enhance its market standing. In some cases, the adoption of accrual budgeting corresponded with the establishment of other new budget planning and reporting procedures designed to institute forward looking budgetary frameworks and reports.[19]

Accrual Budgeting Adopted for Greater Transparency and Accountability

In general, the case study countries adopted accrual budgeting in reform environments which stressed the need to improve the "transparency" of the budget process and invite increased scrutiny of fiscal policy and specific spending initiatives. For example, Australia's Charter of Budget Honesty and New Zealand's Fiscal Responsibility Act each mandate the release, at the start of the budget process, of fiscal strategy statements setting the broad strategic goals of the government. Subsequently, the budget represents how the government intends to implement its strategy. These two countries viewed an accrual framework as important in supporting

[19] In the United States, the Congressional Budget Office produces 10-year outlay-based projections for use in the budget process.

efforts to improve transparency. In particular, proponents in New Zealand informed us that cash-based budgeting followed inconsistent and complex practices understood by only a few practitioners. In contrast, private sector standards were viewed as generally accepted and understood. Consequently, proponents view applying these standards to the budget as helping to ensure that the budget is understood and subject to greater public scrutiny than was possible when the budget was cash-based.

Proponents stated the opinion that budgeting based on accounting standards increased the consistency and credibility of budget information because the accounting standards are independently developed, well documented, and may be more readily understood. For example, in New Zealand, applying private sector or other established accrual accounting standards was viewed as improving the credibility of government financial management in the credit markets. New Zealand had experienced loss of market confidence—partly attributable to government's poor fiscal management—and faced the prospect of credit downgrades. Reform efforts including accrual budgeting were begun, at least in part, to regain the trust of the credit markets. Officials in the United Kingdom and New Zealand told us that they believe the adoption of standards for budget development and presentation that mirror private sector accounting standards will enhance the credibility of budget estimates in the public debate. Officials told us that in their opinion, budgeting based on these standards provides consistency and reliability which can help instill confidence in the estimates and in the ability of the government to achieve its fiscal targets.

Improving the consistency between the budget estimates and the financial statements was also seen as important to enhancing parliamentary scrutiny. Proponents expressed the belief that lack of comparability between the information in the budget and the information decisionmakers receive on the actual results of their budget initiatives in accrual-based financial reports was problematic. For example, officials from New Zealand, Australia, and the United Kingdom all noted that differing budgeting and reporting standards generally provided conflicting signals to decisionmakers and could lead to the failure to adequately focus on results and performance. They viewed the alignment of the basis of budgetary measurement with that used in financial accounting standards, i.e., accrual, as providing a consistent basis with which to make comparisons.

Accrual Budgeting Raised New Accountability and Transparency Concerns

Just as different budget structures highlight different issues, they can bring to the forefront different trade-offs. Budgetary accounting may hide or make transparent the implications of given choices and so confer an advantage or disadvantage. In some cases the trade-offs highlighted in an accrual budget are different than those that would have been presented for the same budget proposal under a cash budget. Although decisionmakers were expected to benefit from any new information that would be available as a result of accrual budgeting, its use—especially in support of more decentralized, performance-focused management philosophies—also raised some new accountability and control concerns.

Some forms of accrual budgeting may provide less control by top-level decisionmakers over some budget items. This is especially true for capital assets where, on an accrual basis, parliamentary decisionmakers may have less ability to control asset purchasing decisions than with a cash-based or obligation-based budget. As previously noted, in New Zealand, Australia, and the Netherlands cash is appropriated for noncash items, such as depreciation expense, and agencies will be allowed to save for asset renovation or replacement. Proponents in these countries argue that this discretion is key to encouraging effective management and that compensating controls can be established to alleviate these concerns. However, critics have raised concerns that delegating asset purchase authority to departments entails surrendering control over decisions that should be made in a governmentwide arena. This delegation could limit the government's ability to make trade-offs across agencies in the use of scarce resources. It also ties funding for new assets to existing assets through depreciation which fails to recognize changes in needs. For example, this process could provide too much for agencies with declining demands for assets and too little for agencies with expanding asset needs. It is unclear whether the compensating controls that were instituted to provide for parliamentary review of most asset purchases offset these problems.

Monitoring budget execution on an accrual basis presents new challenges. Under cash- and obligation-based budgeting, oversight of budget execution is relatively straightforward because managers usually do not have access to more cash than they are expected to use in a given period and obligations are closely monitored to avoid breaching the amount permitted by law. Under these types of budgeting systems, oversight of budget execution generally involves reviews of obligations incurred and cash disbursements to ensure that payments are made in accordance with authorized purposes.

Some we spoke with expressed concerns that the increased complexities associated with the use of accruals may lead to reduced transparency and control. These challenges arise because, depending on the accrual approach used: (1) cash may be appropriated for noncash expenses, (2) some accrual-based amounts are based on assumptions and judgments which must be understood to reduce the potential for error or manipulation, and (3) when combined with output-based budgeting, wide discretion is provided over the use of resources. For example, parliamentary staff in the United Kingdom expressed concern about the ability to understand the reconciliation between cash requirements and accrued costs. Further, observers in New Zealand expressed concern that in the absence of truly competitive environments, the lack of detailed input information makes it difficult to judge departmental performance, especially the reasonableness of the output "prices" on which the system is premised. Under an accrual budgeting model, oversight may be grounded in financial management principles such as asset/liability management and the sustainability of projected cash flows. For example, in Australia, departmental performance will be monitored based on assessment of departmental operating statements. This is important in these systems because, as departments are given significant discretion over how funding is used to produce outputs, oversight is premised on the ability of policymakers, as the purchasers of goods and services, to adequately assess the price and quality of outputs. As a result, understanding the full costs of producing goods and services, rather than just the immediate cash outlays, becomes increasingly important to ensuring accountability.

These issues and other oversight challenges will be discussed more fully in chapter 4.

Countries Developed Mechanisms to Cope With Budget Control Issues

Proponents noted various mechanisms which can help address control issues. For example, officials from several countries, including New Zealand, Australia, and the United Kingdom, pointed to corresponding enhancements such as alternative measures of fiscal performance, increased requirements for strategic and investment planning, and increased accountability for performance. For these reasons, proponents argued that it was important to consider a country's entire accrual-based management framework when considering issues of control and accountability. For example, limits may be placed on managerial discretion by fiscal targets that govern key budgetary decisions and continue to be measured primarily on a cash basis. Officials argued that if total borrowing is constrained through fiscal policy objectives, such as debt-to-GDP targets,

it may be more difficult for departments to justify capital injections (cash advances) for an asset purchase price even if only one year's depreciation expense would be recognized in the accrual-based budget.

All case study countries that adopted accrual budgeting continued to use some cash-based measures to monitor fiscal policy. For example, New Zealand uses an accrual-based operating balance as its primary deficit or surplus measure, but continues to monitor its debt-to-GDP ratio—a cash-based measure. Officials explained that the debt-to-GDP ratio is a key fiscal target which, used in conjunction with an accrual-based surplus or deficit, provides additional information for decisionmakers to undertake fiscally cautious decisions that contribute to improving the fiscal health of the country.[20] In fact, New Zealand officials and experts we interviewed explained that setting debt targets guides the determination of the accrual-based surplus or deficit target.

In the United Kingdom, the adoption of a fiscal framework which more clearly distinguishes between current and capital spending was intended in part to encourage capital investment. Nevertheless, the Parliament has asked that the new appropriations bills include a reconciliation at the departmental level between resources consumed (accrual amounts) and cash. Furthermore, they asked to vote on the departmental cash reconciliation as well as on the resources allocated at the activity level. These votes are intended to draw attention to the cash needs of the budget and demonstrate an interest in continuing parliamentary review of these cash resources.

In Australia, debate continues over whether the dominant measure of fiscal position should be accrual- or cash-based. Some who advocated that the primary measure of fiscal position be accrual-based stated that in order to most fully influence behavior, the government should use as its primary measure the same measure to which departments are held accountable. Others expressed the view that that cash-based measures are a better indication of the government's role as steward of the economy and, additionally, are more familiar to the public. While Australia's budget is presented on an accrual basis, the budget balance—or bottom line—is adjusted to represent the cash financing requirements.

[20] For more detailed discussion of this topic see *Budget Surpluses: Experiences of Other Nations and Implications for the United States* (GAO/AIMD-00-23, November 2, 1999).

Aside from constraints imposed through cash-adjusted and cash-based fiscal targets, some case study countries imposed other controls at different levels in the budget process. For example, successive reforms in New Zealand—the State Sector Act of 1988 and the Public Finance Act of 1989—changed the locus of accountability in the public service by holding executives responsible for their performance through public service contracts. The new public service system is characterized by executive discretion over the hiring and firing of managers and other employees should performance not measure up to the expectations set forth in their contracts.

In addition, in some countries Cabinet scrutiny ensures that cash controls are still in place at an overall governmental and fiscal level. In Australia, for example, the Expenditure Review Committee, which is responsible for making budget decisions, retained its focus on incremental changes and cash requirements. Further, the Department of Finance and Administration (DoFA) will continue to review the monthly expenditure reports to ensure that departmental spending is in line with what has been budgeted and appropriated. Although ultimate accountability for any breach in budgeted appropriations lies at the department level, DoFA expects to review spending trends and advise senior decisionmakers if financial management is suspect. Similarly, in New Zealand, the timely availability of monthly financial statements was viewed as allowing analysts in the Department of Treasury to determine whether departments are on track to deliver outputs within the agreed upon price, or on the verge of breaching their appropriations.

Conclusion

Case study countries expressed the view that accrual budgeting is a useful tool in addressing concerns about public performance, sustainability, and accountability. Some proponents view it as necessary to support more decentralized, performance-focused management by improving links between cost and performance. Accrual budgeting was viewed as providing decisionmakers with more complete information on sustainability of some government policies with long-term budgetary implications. Finally, proponents expressed the belief that accrual budgeting would improve accountability and control by enhancing the consistency and transparency of budget information. This last point was challenged by other observers who expressed concerns and skepticism that the increased complexities of accrual measurement and the decentralization of responsibility that accompanied most of the case study countries' budget reforms present difficult trade-offs that might offset the benefits proponents expect to

achieve. Finally, some question the usefulness of accrual budgeting in addressing sustainability issues because it does not capture some key fiscal pressures—those associated with social insurance and health care programs.

The design of an accrual budgeting system shapes its role in addressing these challenges and tends to reflect a country's overall management approach and desired level of control. For example, the extent to which the adoption of accrual budgeting reflected fundamental changes to core management philosophies and systems varied significantly. Some countries, such as New Zealand and Australia, integrated accrual budgeting with output-based appropriations to support decentralized, performance-focused management systems. The United Kingdom plans to use accrual budgeting to better recognize costs but to date has not chosen to shift to output-based appropriations. Conversely, Iceland's accrual budgeting system, which excludes capital and accrues pension costs only at the central level, better reflects aggregate costs to the government but places less emphasis on allocating full costs to particular goods and services. In general, the design of a country's accrual budgeting system tended to reflect its key concerns and reform objectives.

Challenges in Implementing Accrual Budgeting

Case study countries faced a number of challenges in implementing their accrual budgeting systems. First, they had to determine what standards to use to measure accrual amounts in the budget. To varying degrees, countries also had to develop new systems to collect and analyze accrual-based data. In addition, countries faced challenges with respect to asset identification and valuation, oversight of budget execution, and cultural change. Most countries felt that strong leadership and extensive education efforts were key to addressing these implementation challenges.

Countries Faced Some Common Implementation Challenges

In our case study countries, a key rationale for moving to an accrual budget was the desire to use a consistent set of standards for financial statements and for the budget. Although the process for developing public sector accounting standards differed in each country, they all adopted accounting standards similar to those used by the private sector in their countries. The adoption of standards developed by an independent body was viewed as increasing the consistency and credibility of budget information. With some modifications, the accounting standards were adopted for budgeting as well. Most of the countries found they needed new information management systems to collect accrual-based data and in some cases to facilitate reporting under new output/outcome-based account structures. In the transition from a cash-based reporting environment to accrual-based frameworks countries faced further challenges with respect to

- asset identification and valuation,
- oversight, and
- cultural change.

Identification and Valuation of Assets Presented Difficulties in Move to Accrual Framework

Asset identification and valuation were cumbersome and time-consuming efforts for the countries that chose to capitalize assets. Indeed, one of the reasons that Iceland decided against capitalizing assets was the difficulty it would have faced in identifying and agreeing on the asset values. Even in countries that have accounting standards in place to provide guidance on asset valuation, the valuation of individual assets can be subjective. For example, unique assets such as national parks, military weapons systems, and infrastructure proved very difficult to value.[1] Further, some suggested that funding of depreciation creates an incentive for departments to overvalue their initial asset base to ensure higher funding levels to replace assets in the future.

Different approaches were used for asset valuation and identification. In New Zealand, the use of different approaches across departments was cited by some as raising concerns about the reliability of the estimates and the "fairness" of the funding levels across government. For example, the Department of Education (DOE) hired an independent contractor to assist with asset valuations. Other agencies assessed the value of their assets themselves. Officials noted that departments as diverse as the Department of Defense, DOE, and the police department have had problems identifying assets and/or determining their ownership. Officials from the other countries which chose to capitalize assets expressed similar views that much time was spent on trying to get asset registers right.

The allocation of assets among departments at the time of the change to accrual budgeting also may affect future operations. Under accrual budgeting approaches in which depreciation funding is to be used to maintain the existing asset base, the issue of whether the initial asset mix is optimal may have unintended consequences. For example, in New Zealand there was an implicit assumption that departments began accrual budgeting with the capital necessary to ensure the sustainability of their activities. Under accrual budgeting, depreciation funding permitted renovation or replacement of the existing asset base. As a result, some

[1] In the United States, there has been debate surrounding the treatment and valuation of unique governmental assets such as weapons systems and heritage assets. In considering this issue, FASAB suggested that (1) the value of some federal assets, such as museums and national parks, may be indeterminable and (2) allocating the costs of assets such as military weapons systems to accounting periods may be meaningless. In response to these difficulties, FASAB required a new category of financial reporting, "required supplementary stewardship information," which is to accompany financial statements but is not included directly on the balance sheet.

equity problems have arisen between departments that were asset-rich and those that were asset-poor at the time of the change to accrual budgeting. Departments that were asset-rich when the new system was implemented were able to maintain their asset bases regardless of shifts in relative spending priorities and demand for services. Officials found that some asset-rich departments have been able to install up-to-date computer systems because the price of their outputs was based on operating expenses that included depreciation costs for a large asset base and they had accumulated their depreciation funding. In contrast, asset-poor departments were not able to accumulate much depreciation funding and were unable to fund new, more expensive, replacement assets. Officials warned that these departments had been forced to run down their asset bases and may need capital injections in the near future. Some believed that such capital injections will be difficult to get in the future.

Management and Oversight Roles Will Be Affected by Use of Accrual Budgeting

Accrual budgeting presents new challenges for the management and oversight of public funds. Accrual measurement requires the use of judgment regarding, for example, the estimated useful life of an asset, the recognition of a contingent liability, and revenue forecasting. Decisionmakers will need to understand how such judgments can affect a department's budget request. The change in management and oversight of public funds will, perhaps, be most dramatic in those countries that have adopted an output-based model because such models inherently focus less on control over inputs. Rather, output-based models are premised on the ability of decisionmakers to assess the appropriateness of the "price" of outputs. Some countries made various attempts, such as crosswalks between cash and accrual reports, to assist decisionmakers in performing their oversight roles.

Decisionmakers Sought Crosswalks and Reconciliation to Cash

Many users of budget documents, notably members of Parliament and their staffs as well as observers outside of government, expressed an interest in having a crosswalk between the last fiscal year in which a cash budget was presented and the first fiscal year in which an accrual budget is presented. They thought this would help the users understand the implications of the shift in budget measurement. Some countries have accommodated this desire for crosswalks while others, for various reasons, have not. For example, in Iceland as the reforms were being debated in the Althingi, the Ministry of Finance presented budgets for the two previous fiscal years on both a cash and an accrual basis providing decisionmakers a clear idea of what information might be lost and what was gained in the change. Members of the Althingi and other senior government officials indicated

that this approach was helpful in gaining widespread support for the reforms. Iceland requires the budget to be presented on both a cash and an accrual basis, although the detailed spending estimates are presented only on an accrual basis.

In the United Kingdom, the Parliament has requested that the proposed period of dual running of the old cash system and the new accrual-based resource system be extended to allow time for increased understanding of the implications for parliamentary control and oversight. The Treasury opposes the extension and has testified that doing so would be too costly and could undermine incentives to move to the new system. In contrast, in New Zealand, officials found no need for cash information after the first transitional budget was produced. Treasury officials said that after consulting with various users of budget information, including parliamentarians, experts, and the press, a consensus was reached to forgo future presentation of cash-based supplementary budget information.

Crosswalks to cash could not be implemented in Australia primarily because the adoption of accrual measures also coincided with the adoption of a new budget framework. Resources will no longer be appropriated by object classes to specific departments and agencies; rather, appropriations structures have been "remapped" to show the allocation of resources to outcomes and outputs to more effectively account for the full costs of those programs and activities. Budget officials in Australia said that a crosswalk between the last fiscal year's cash-based budget and the new accrual-based budget would not be practical, largely due to the fact that a new information management system was developed to allocate resources to outputs and the cash-based information would not be collected in accordance with this new framework. Instead, the previous fiscal year's budget was reestimated on an accrual basis to highlight the differences between cash and accrual estimates.

New Analytical Skills Are Required for Oversight

In addition to understanding how accrual-based budget requests compare to the previous cash-based requests, parliamentarians must be able to understand basic accounting concepts, such as depreciation and revaluation, and the implication of their use in order to perform their oversight responsibilities. For some items, financial statement and budget reporting on an accrual basis requires more assumptions and judgment than cash-based reporting. However, independent auditors provide assurances as to the reliability and reasonableness of these judgments in their review of the financial statements. On the other hand, when budget estimates are presented for parliamentary approval no such independent

review has been undertaken. A department's request for depreciation expense, for example, may have increased from the previous year due to a revaluation of assets that has not yet been subjected to independent audit. Consequently, absent further scrutiny, these estimates could be enacted into law and cash appropriated to the departments for expenses that may be overstated. This concern has been addressed in different ways. For example in Australia, departmental budget requests are reviewed by analysts in the Department of Finance and Administration (DoFA) and compared to the department's most recent audited financial statements and to requests made during recent budget cycles. In New Zealand, because output prices are rarely changed, any higher depreciation expenses resulting from asset revaluations would have to be absorbed by the agency. If an agency were to insist that as a result of the higher depreciation costs it needed additional appropriations, the request would require considerable justification and review of its assumptions in order for the minister to agree to a "price" increase for that department.

Some observers expected that the shift in the focus of parliamentary scrutiny of budget estimates would pose challenges. Some experts in New Zealand felt that the focus on output funding instead of input funding could provide opportunities for departments to mask data because the new reporting framework[2] does not provide information on the mix of inputs used to produce each specific output. For example, social work services to children and young persons is one output requiring an appropriation of almost NZ$190 million. Although the output is defined by various performance standards, such as the number of notifications investigated or the number of orders in force, the appropriation documents provide no detail as to the mix of personnel, overhead, or technology used to provide the output. Consequently, it can be difficult to determine whether an output was achieved by extracting efficiencies or by running down and not replacing needed assets.

Furthermore, as departments redefine outputs over time, the lack of input information may make it difficult to compare performance on a consistent basis. Moreover, output classes are defined inconsistently—some in more detail than others—which makes meaningful comparisons within and across departments challenging. Some observers noted these factors have

[2]For more information on New Zealand's output pricing model of accrual budgeting see appendix V.

the potential to complicate oversight now that the departments have been given a great degree of managerial discretion.

In Australia, some parliamentary staff said that trying to change the focus of parliamentary oversight from its current focus on inputs—the cash budgeted for personnel, supplies, and overhead—to departmental performance and output prices may present challenges because the issues are complex and the committees tend to be understaffed. Australia's new budget framework, which encompasses much more than accrual budgeting, seeks to link appropriations for outputs purchased to outcomes such as "Stronger Families." These broad outcomes represent the current government's policy initiatives; outputs represent what the government purchases in order to achieve the desired policy outcomes. Moving the focus of oversight from detailed inputs to broad outcomes presents an additional level of complexity because in many cases an outcome requires contributions from many agencies and is affected by numerous public and private factors. Also, in many cases direct causal links have not been established between outputs and outcomes.

Assessing Prices Is Critical to an Output-based Approach to Accrual Budgeting

Under output budgeting frameworks, the government agrees to purchase outputs from the departments at agreed-upon accrual-based prices. Conceptually, the government and the Parliament should be able to ascertain whether the output price is fair based on comparisons with similar services offered in the private sector or by other government agencies. However, many argue that because private markets do not exist for numerous government services, benchmarking will be difficult. New Zealand, with more experience in output budgeting than any other country, is still grappling with this issue. Officials said that the benchmarking exercise is difficult for a number of reasons. First, analyzing the price of a publicly funded activity can be complicated. For example, a few years ago the Customs and Treasury departments analyzed the processing of in-bound passengers. Even this simple process had to be broken into surveillance, baggage checking, paper processing, etc. As a result, it took 6 months to fully understand the process and assign a price to each component. Once such a process analysis is complete, finding an exact private sector equivalent against which to benchmark prices is not straightforward, partly because there is often no private sector counterpart that performs the same function as a sovereign government entity. New Zealand appropriates to more than 750 outputs, but as of fiscal year 1999-2000 only a few output prices had been successfully benchmarked. Many officials said that this exercise was only just beginning and most

appropriations continued to be closely tied to departmental operating costs.

Similarly, in the Netherlands, the goal of the accrual budgeting framework[3] is to encourage agencies to benchmark their prices against other providers—public or private—of similar services, but even after 6 years this has been done infrequently. Instead, the price usually reflects the costs of production. The lack of widespread benchmarking to determine prices was attributed to inexperience with accrual measures, the recent accession of many new agencies in the program, and the fact that for some of the services these agencies provide there is no private sector equivalent that can be used for benchmarking.

Cultural Change Was Necessary to Achieve Benefits of Accrual Budgeting

As with any major reform effort, significant cultural change was viewed as important to ensuring successful implementation of accrual budgeting. The shift to an accrual budget, especially in Australia and New Zealand, was part of a major change in how departments requested and would be held accountable for resources. Shifting accountability from central oversight agencies to individual departments changed the way financial resources were controlled. Many officials described these changes in control and the focus of information as "cultural changes," signaling the magnitude of the challenges and the possible resistance to the implementation of the reforms. These concerns were largely addressed through extensive training efforts on accrual techniques specifically and, more generally, on the benefits expected from the broader reform efforts.

Implementation time frames varied significantly across case study countries. There is little consensus, however, regarding the appropriate length of time needed for implementation. The United Kingdom's implementation approach provides for a long phase-in period for the reforms: over 6 years will have passed between 1994, when the government issued a "white paper" signaling its intention to proceed with budget reforms, and 2001 when the first accrual-based budget is to be presented in Parliament. Treasury officials said that they were able to take advantage of the long time frame to thoroughly vet the reporting standards, train personnel, and perform "dry runs" of the new budget presentations. Some believe that even 6 years is not long enough to fully prepare for the reforms. Others in the Treasury argue that the long lead time allowed departments to

[3]See appendix IV for more information on the Netherlands' accrual budgeting framework.

"put off" the inevitable. In contrast, Australia introduced its first accrual budget within 18 months after laws requiring a shift to accrual budgeting had been enacted. However, problems with quick implementation were noted in Australia where officials expressed frustration at trying to provide training on policy changes while the policies were still being developed.

Leadership Commitment and Extensive Training Are Keys to Addressing Implementation Challenges

In all countries, commitment to financial reporting and budgeting reforms from the top levels of government was considered crucial to successful implementation. In addition to management commitment, extensive training helped increase general understanding of the benefits to be achieved and reduced the resistance to change.

Demonstration of Leadership Commitment Essential for Successful Implementation of Reforms

A key factor in successfully moving to accrual budgeting was the strong support from both the political leadership and within the bureaucracy. In New Zealand, politicians' needs for better financial and managerial information provided the impetus behind the passage of the Public Finance Act. The act significantly changed the managerial accountability and incentive structure. Under the new system, all managers are required to sign limited-term contracts and are subject to annual reviews based on quantifiable performance criteria. If not met, contracts were not renewed for another term. According to many observers, once departmental managers recognized the degree of change necessary to implement these reforms and the implications for not meeting their contractual obligations, their own commitment to making the changes increased significantly.

In Iceland, financial reporting reform legislation was debated for nearly 3 years in the Althingi before it was enacted. The bill passed by unanimous vote, an outcome sought by the government to ensure the widest possible support for these reforms. While punitive incentives were not imposed in Iceland as they were in New Zealand, the extent of the debate and the support of the political leadership from all parties sent a strong signal. In addition, to ensure the consistency of the new measurement basis and to ease its implementation and use in the budget process, most of the more complex accrual analyses were done by the Ministry of Finance, consolidated in its budget, and not allocated to individual departmental budgets.

In the United Kingdom, the impetus to move to accrual budgeting has continued despite changes in the parties controlling the government. A senior Treasury official noted that a key factor in the successful implementation of accrual budgeting has been the strong ministerial backing from the start, under both Conservative and Labour governments. These officials said that politicians viewed the reforms as grounded in the goal of providing managerial improvements and better information to Parliament. Equally important, the reforms had support from the senior level within Treasury which ensured a consistency of staff responsible for designing and implementing the reforms.

In Australia, support for the reforms at the ministerial level was ensured through direct dialogue between the Minister of Finance and Administration and his colleagues in the Cabinet. The expectation followed that Cabinet ministers would reinforce the importance of the reforms throughout the departments in the ministers' portfolios. These reinforcements complemented training strategies that were geared towards further emphasizing the government's commitment to the reforms.

Multifaceted Training Methods Used to Support Cultural Change

Training played a key role in most countries to ensure that accrual concepts were well understood. But more important, training opportunities were also used to ensure the dissemination of information on and a clear understanding of the government's commitment to these reforms and to instill an equal commitment to and understanding of the reforms at every level of the bureaucracy. In Australia the outreach effort to inform and educate departmental personnel was undertaken by DoFA. The training curriculum was designed to reach multiple levels of management through the use of different communication tools and techniques such as seminars, speeches, focus groups, newsletters, and Internet web sites. Most importantly, the training curriculum could be redesigned for different levels of management depending on the needs of the users. DoFA officials believe that the use of a multifaceted, multimedia approach facilitated communication about the reforms, allowing them to address departmental concerns as quickly as possible.

Officials at the United Kingdom's National Audit Office also believe that training will be essential to successful implementation of accrual-based resource accounting and budgeting and that a huge education effort is necessary to ensure that staff at all levels are technically equipped to understand and implement basic accrual requirements. Individual departments prepare and implement their own training programs by taking

pieces of the curriculum developed by the Treasury. Treasury has taken the role of facilitating the exchange of ideas through a "training network," which they believe also supports a key objective in delegating more authority and responsibility to the departments.

Furthermore, as accounting issues typically garner little management interest, the link to the budget has worked to increase interest in the overall reforms. Many departmental personnel are realizing that their budget will soon be measured differently and this will affect their funding levels. Officials in the various departments that are in charge of training suggested that as a result of these linkages, staff are paying more attention to the reforms than might have otherwise been expected.

Observations

Case study countries faced some common challenges in implementing their accrual-based frameworks. Most countries found that they needed new information management systems to support the collection of accrual-based data and, in some cases, to facilitate reporting under new output/outcome-based frameworks. In addition, country officials reported significant challenges in asset identification and valuation. Further, the shift to accrual-based financial and budget reporting required a significant cultural change with implications for managerial and oversight roles. Cultural change and the concomitant managerial and oversight role changes were most pronounced in countries which combined a shift to accrual budgeting with output-based budgeting. Leadership commitment and extensive training were identified as crucial in addressing these implementation challenges.

Adapting Accrual Budgeting for the United States Context

The United States and the countries in our review share common objectives of improving the efficiency, effectiveness, and sustainability of government activities while enhancing transparency and accountability. To varying degrees, case study countries have turned to accrual budgeting as a tool in addressing these issues. Despite obvious and significant political, cultural, and economic differences, these countries' early experiences with accrual budgeting provide some valuable insights for the United States. Their experiences, however, must be seen in context of their particular situations and any translation to the United States should be done within context of its situation and political structure.

Accrual budgeting in some case study countries was coupled with initiatives to devolve authority and accountability to executive agencies. The United States, unlike the case study countries, has a separation of powers between the executive and legislative branches of government with the Congress taking an active role in resource allocation decisions and oversight. The challenge becomes how to translate useful ideas developed in a parliamentary political system to the U.S. system. Any reform efforts need to be adapted to meet the unique budgeting needs of both the Congress and the executive branch in the U.S. system. This chapter explores the implications accrual budgeting could have within the United States' unique constitutional framework and focuses on ways to adapt accrual concepts to enhance the information available to the Congress and the President in considering budget decisions. Accrual concepts can effectively serve to enhance accountability by the Congress as well as the executive branch for certain types of budgeting decisions, particularly those involving commitments of future budgetary resources.

To understand the implications of accrual budgeting it is necessary to consider the goals of the federal budget process. Although the U.S. cash- and obligation-based budget may not fully recognize long-term commitments or directly match full costs with the provision of goods and services, it nevertheless offers other benefits, particularly for up-front budgetary control of the purchase of capital assets. Accrual budgeting based on financial accounting standards can be used to better match costs with the provision of goods and services, but whether it would result in earlier budget recognition than the current cash- and obligation-based budget depends on the budget item. Accrual budgeting would advance the recognition of costs for items, such as pensions and insurance, that involve cash flows over many years, but would delay it for capital assets so as to spread costs over the periods that benefit from their use. In this sense, the decision about whether to apply accrual budgeting based on financial

accounting standards for the entire budget depends on the relative importance one places on recognizing and controlling costs at the time decisions are made versus the matching of costs to the period resources are consumed in the provision of goods and services. In the United States, specific concerns about the implications for budgetary control would be raised if some accrual budgeting approaches were applied to capital assets; this concern is especially great with regard to control over asset purchases. Further, accrual budgeting, as implemented by the case study countries, ameliorates but does not "solve" the problem of inadequate recognition of long-term commitments since social insurance commitments are not included.

The differences between the United States and the case study countries in the budgetary role of the legislative branch make it unlikely that any case study country's accrual budgeting approach would be fully applicable for the United States. Nevertheless, several useful ideas still can be drawn from their experiences. For example, the experiences of Iceland and New Zealand suggest that using accrual budgeting for some programs, such as pensions and insurance could result in better information and incentives for budgetary decision-making. Further, while accrual budgeting as implemented by case study countries would not address long-term commitments associated with social insurance, it would be possible to develop budgeting approaches drawing on accrual concepts but not specifically wedded to financial accounting standards. Finally, while accrual-based output budgeting models adopted by New Zealand and Australia are not likely to be adopted fully in the United States, their experiences with clearly aligning budget and performance information within an integrated accountability framework in order to support performance management reforms could prompt some further exploration of ways to better match costs and performance without sacrificing up-front control.

Performance, Sustainability, and Accountability Central to U.S. Reform Efforts

The United States and the countries in our review share common objectives of improving public sector financial and performance management while enhancing transparency and accountability. As in these other countries, decisionmakers in the United States recognize that the federal government could benefit from greater integration of financial accounting and performance reporting in the budget decision-making process. At the same time, changing demographics and other factors have raised questions about the sustainability of the government's long-term commitments, such as Social Security, Medicare, and Medicaid.

In response to the desire to improve effectiveness and accountability while limiting costs, the Congress established a statutory framework to address key management issues. Two major laws are at the heart of this framework: the Chief Financial Officers Act of 1990 (CFO Act) and the Government Performance and Results Act of 1993 (the Results Act).

The CFO Act—as expanded by the Government Management Reform Act of 1994—was designed to remedy decades of serious neglect in federal financial management. For example, the act, among other things, established chief financial officers across the government, called for improved financial management systems and controls, including cost accounting, and required the preparation of audited annual financial statements for the 24 largest agencies and for the government as a whole. To improve the usefulness of federal financial reports and ensure public accountability, the Federal Accounting Standards Advisory Board (FASAB) was established to develop accounting standards suitable for the federal government.[1] FASAB completed work on the basic set of Federal Financial Accounting Standards (FFAS) in 1996, but some standards did not become effective until 1998 and 1999.

These efforts are prompting steady improvements in federal financial accountability, but more work remains. Major agencies covered by the act are issuing agencywide financial statements and the U.S. government has prepared and subjected to audit consolidated financial statements for the government as a whole. However, our audits of the 1997 and 1998 consolidated statements revealed serious deficiencies—including systems weaknesses, problems with fundamental recordkeeping, and weak internal controls—which prevent the government from accurately reporting a significant portion of its assets, liabilities, and costs. Because of these deficiencies, we were unable and did not express an opinion on these financial statements.[2] As these findings indicate, there are major obstacles, both at the agency and consolidated levels, in preparing reliable financial statements for the U.S. government.

[1]The Federal Accounting Standards Advisory Board (FASAB) was established in October 1990. See chapter 1 for more detail.

[2]*Financial Audit: 1998 Financial Report of the United States Government* (GAO/AIMD-99-130, March 31, 1999) and *Financial Audit: 1997 Consolidated Financial Statements of the Untied States Government* (GAO/AIMD-98-127, March 31, 1998).

While the CFO Act established the foundation for improving financial management and accountability among agencies, the Results Act aimed more directly at program performance. Under the Results Act, agencies are required to set multiyear strategic goals and corresponding annual goals, measure performance toward achievement of those goals, and report on their progress. Among its several purposes, the act is designed to improve congressional decision-making by providing information on the effectiveness and efficiency of federal programs and spending. That is, with regard to spending decisions, the act aims for a closer and clearer link between the process of allocating resources and the expected results to be achieved with those resources. This is viewed as important to shifting the budget debate from a focus on inputs to a focus on performance.

There also has been a growing recognition that policymakers need information on the long-term cost consequences of today's commitments. The long-term costs implied by the government's current commitments can encumber major shares of future budget resources, thereby constraining the government's fiscal policy. Our long-term budget model illustrates that the growth in Social Security and health commitments threatens to crowd out discretionary spending in the long run, assuming a constant tax burden. This is particularly important for programs such as Social Security and Medicare that require long time horizons to understand the implications of the government's commitment and its impact on fiscal policy. The congressional budget process has made progress in considering the longer term in budgeting by requiring a multiyear focus, including the use of a 10-year budget window. Further, the Federal Credit Reform Act of 1990 changed the method of budgeting for credit programs to an accrual basis to provide more timely recognition of their costs to the government.[3]

[3]See chapter 1 for more detailed discussion of the Federal Credit Reform Act.

These reforms represent significant steps towards improving budgeting, financial information, and performance management and have begun to provide the tools for better management. At the same time, additional challenges remain to ensure that high performance principles become an integral part of the government's operating culture rather than just paperwork exercises. For example, agencies face significant challenges in improving linkages between performance plans and budget requests. As we have reported earlier, tensions exist between the needs of planning and budgeting structures. While budget structures have evolved over time to help the Congress control and monitor agency activities and spending, planning structures tend to be broader and wide-ranging in order to articulate the mission and outcomes agencies seek to influence. Despite these tensions, better integration of planning and budgeting is important to meeting key expectations of the Results Act.[4] Similarly, while the audited financial statements required by the CFO Act provide important information on the government's assets, liabilities, and overall financial position, integrating this information to better inform budget decisions remains a challenge. Further, although the multiyear focus of the Deficit Control Act (DCA)[5] represented progress in considering longer-term budgeting, it did not fully address sustainability issues. This is particularly important for programs such as Social Security, Medicare, and Medicaid, whose rising costs are key drivers threatening the sustainability of the government's fiscal policy. Although considerable long-term actuarial analyses of Social Security and Medicare costs have been done, the cash-based budget is not currently structured to focus on the long-term outlook for these commitments.

Countries in our review turned to accrual budgeting, at least in part, to help address similar concerns about public sector performance, sustainability, and accountability. Overall, proponents stressed the value of moving beyond accrual-based financial statement reporting to using accrual-based information in the budget—the key accountability and decision-making mechanism—in heightening the awareness of and responsibility for addressing these concerns.

[4] *Performance Budgeting: Initial Agency Experiences Provide a Foundation to Assess Future Directions* (GAO/T-AIMD/GGD-99-216, July 1, 1999).

[5] The Balanced Budget and Emergency Deficit Control Act of 1985 as amended by the Budget Enforcement Act of 1990, the Omnibus Budget Reconciliation Act of 1993, and the Budget Enforcement Act of 1997. The DCA as amended established statutory limits on federal government spending for fiscal years 1991 through 2002.

Transferability of Other Nations' Experiences

Despite obvious and significant political, cultural, and economic differences, these countries' early experiences with accrual budgeting provide some insights that may be helpful to the United States. Their experiences, however, must be seen in the context of their particular situations and any translation to the United States should be done in the context of its situation and political structure. It is important to consider key differences between (1) the legislative bodies in a parliamentary system of government and the Congress of the United States, especially in terms of the role each plays in the budget process, and (2) the methods of budget reporting already in place in each country. In addition, the implications of other reforms undertaken at the same time as accrual budgeting need to be considered. Given the differences between the United States and the other countries in all of these factors, it is unlikely that the United States would achieve all of the benefits claimed by case study countries. However, some benefits could result from the selective use of accrual budgeting, as has already been demonstrated for credit programs.

Parliamentary bodies in our case study countries exercise their influence differently than the U.S. Congress. Governments are formed by the political party, or coalition of parties, that hold the support of a majority of Parliament. As such, the line between the executive and the legislative functions is not as clear as it is in the United States where the separation of powers serves as a check on each branch's power. Many important budget decisions that, in the United States, are debated and settled during the annual appropriations process, occur in the case study countries before the budget is presented for parliamentary approval. Parliament's duty is to satisfy itself that the current government has the Parliament's full confidence to continue governing. If it is satisfied on that front, case study countries' parliaments regularly enact the government's budget without amendment. In Westminster systems, the failure to do so would be viewed as a statement of "no confidence" in the government and would signal a need for new elections, including for a new Parliament. The separation of powers also has implications for budget accountability as the Congress generally exerts a greater degree of control over agency spending. Most case study countries generally deal with the approval of obligations through executive branch controls whereas in the United States congressional approval (budget authority) is required before executive branch departments can obligate funds.

Further, while most of the countries in our study had previously budgeted on a pure cash basis, the United States has both a cash- and obligation-based budget. A pure cash budget focuses on the cash flows to and from the government in a given period. The United States' obligations basis of budgeting focuses upon controlling the legal obligations entered into during a period.[6] The U.S. budget is also referred to as cash-based because, with limited exceptions,[7] the amounts to be obligated are measured on a cash basis, and the unified budget deficit/surplus—the key focus of the policy debate—represents the difference in cash receipts and cash outlays in a given year. These differences between pure cash-based budgeting and the United States' cash- and obligation-based budget have implications for assessing the potential benefits to be achieved from the adoption of accrual budgeting.

[6]Obligation-based budgeting involves three stages: (1) the Congress must enact budget authority before government officials can obligate the government to make outlays; (2) government officials commit the government to make outlays by entering into legally binding agreements; and (3) outlays are made in payment to liquidate obligations.

[7]The U.S. budget uses accrual measures to recognize the government's costs for certain programs. For more information see chapter 1.

The information and incentives provided by the budget are shaped by both the measurement basis used to record costs in the budget and the structure of budget accounts (appropriations). The measurement bases discussed in this report—cash, accrual, and obligations—primarily affect the timing at which the budget recognizes costs. In general, controlling the ability to enter into obligations—as is done by the U. S. Congress—provides the most control, especially when obligations are measured in a way that is truly representative of the government's commitment to make future payments. In some cases, such as insurance and employee pensions, obligations measured on an accrual basis would advance the timing of budget recognition and thus enhance the Congress' ability to control. However, for capital purchases, accrual measurement would delay the budget recognition of costs and thus may impair the Congress' ability to exercise control.[8] The structure or scope of budget accounts—i.e., whether budget costs are arranged based on organization, program, or spending item—also help determine the type and amount of oversight and control over public spending.

The case study countries varied in the extent to which they made changes to the budget account structure when adopting accrual budgeting. In two countries, New Zealand and Australia, performance management benefits were attributed to a marriage of output budgeting[9] and accrual budgeting, not a shift to accrual measurement alone. Some observers expressed skepticism that performance improvements would have been achieved solely by a shift to accrual budgeting in the absence of the much greater managerial flexibility provided by output budgeting. This managerial

[8]Proponents of accrual budgeting suggest that compensating controls can be used to address control issues. In most cases, case study countries require appropriations for the annual cash required to purchase assets. However, cash requirements may not cover the full cost of the asset. Legislative approval may not be required for asset purchases below a certain amount if the department can fund them from depreciation reserves. Case study countries also established a number of other compensating controls in an attempt to alleviate control concerns. For example, in New Zealand, managers are not allowed to change the structure of their balance sheets without legislative approval; this is aimed at preventing managers from running down their asset bases to artificially lower the price of outputs. A number of case study countries also established supplemental approval processes for capital projects. See chapter 3 and country appendixes for additional information.

[9]In these countries the shift to accrual measurement in the budget occurred concurrently with a shift to output-based appropriations. In general terms, output-based appropriations provide funding for the total resources required to produce an "output" (a good or service produced by departments on behalf of the government) including costs that do not require an immediate cash outlay, such as depreciation and pension expenses.

discretion over how an appropriation is spent is significantly different from the detailed nature of U.S. congressional control over spending. While these and other factors, such as differences in size and culture, make it unlikely that any of the other countries' accrual budgeting approaches would be adopted in full, their experiences nevertheless provide ideas for the United States to draw upon in addressing its concerns about performance, sustainability, and accountability.

Selective Application of Accrual Budgeting Offers Some Benefits

The challenge is to adapt accrual budgeting concepts used in other countries to address the unique features of the United States' budget process. In particular, the control role played by the Congress in that process means that any adaptations must meet the information needs of that body as well as the President in developing an overall fiscal policy for the nation and in formulating detailed appropriation bills and budget proposals. Thus, while accrual in some other countries was coupled with devolution of authority and accountability to executive agencies, in the United States' setting accrual concepts must address the Congress' needs for better information on the cost implications of its budget decisions.

From this perspective, accrual concepts can help the Congress in those selective cases where using accruals would result in more timely information and recognition of costs. Obligation-based budgeting generally helps ensure that the Congress approves obligations to be entered into by agencies before they are made. Accrual measurement within an obligation-based budget enhances control for programs that involve cash flows over many years, such as insurance and pensions, by recognizing costs earlier when the commitment is made. Doing so would provide a more complete picture of the cost of current decisions and thus may encourage timely changes in these programs to control costs. In contrast, for capital assets, accrual budgeting, by recording depreciation rather than the purchase cost, would delay budget recognition in order to match the cost of an asset with its use in providing services. From a congressional perspective, obligation-based budgeting promotes accountability by recognizing the purchase cost up front and thus permits congressional control over an asset's purchase before the contractual obligation is made. However, for many government activities, such as salaries or grant payments, there generally would not be significant differences in the recognition of costs measured on a cash or accrual basis. The fact that a shift to accrual measurement without compensating controls would erode control over capital purchases and may not result in significant differences for many government activities raises serious questions about whether full accrual would provide

sufficient benefits to warrant its adoption in the United States. However, adopting accrual measurement selectively within an obligation-based control system may prove beneficial. It would provide a means to improve budget information and incentives for decision-making in cases where cash-based measurement is clearly misleading while preserving the up-front control of the obligation-based budget. However, as discussed later, there are limits to which accrual budgeting based on financial accounting standards can be used to address long-term sustainability issues.

The approach developed for credit programs in the Federal Credit Reform Act of 1990 is an example of a selective application of accrual measurement within the obligation-based system. Unlike other programs for which obligations represent cash payments to be made, obligations measured on a cash basis for credit programs sent the wrong signals about the cost of the government's commitment. The initial cost of loans in the budget ignored repayments while loan guarantees initially appeared to be free. The Credit Reform Act required that outlays for credit programs be reported on an accrual basis as the expected cost to the government over the life of the credit instrument.[10] Thus, the obligations that result in those outlays are also accrual-based.

Targets of Opportunity

There are several areas in the budget in which obligations measured on a cash basis do not adequately represent the extent of the government's commitment. In these cases, the annual cash flows recognized in the United States' current budget fail to capture and control the long-term commitment entered into by the government. These areas include

- employee pension programs,
- retiree health programs,
- federal insurance programs, such as deposit and crop insurance, and
- environmental cleanup.

Although the future cost of a portion of civilian and military retirement has been recognized in the budget, the future costs for some of these pensions and for all retiree health benefits and veterans benefits are not. For civilian employees hired since 1984 and personnel in the military service after October 1, 1984, the full cost of pension benefits is recognized in the budget at the department level as they are earned. However, none of the accruing

[10]See chapter 1 for additional details.

costs of civilian or military retiree health benefits or the full cost of retirement benefits for civilian employees hired before 1985 are recognized in the budget. Similarly, the government's cost for veterans' pensions and benefits are not reflected in the budget as they are earned. For these costs, recognizing in the budget the annual benefits earned would provide a truer representation of the commitments that the government has made than reporting cash payments in the year.

Federal insurance is provided to individuals and businesses against a wide variety of risks, ranging from natural disasters under the flood and crop insurance programs to bank and employer bankruptcies under the deposit and pension insurance programs. In the past, we reported that the use of accrual concepts in the budget has the potential to overcome the time lag between the extension of an insurance commitment, collection of premiums, and payment of claims that currently distorts the government's cost for these programs on an annual cash flow basis. Accrual concepts could be used to recognize the government's cost at the time the insurance commitment is made regardless of the timing of cash flows. The government's accrued costs could be measured as the difference between a full risk premium, based on the expected costs of losses inherent in the insurance commitment, and the premium charged to the insured. [11]

Future environmental cleanup costs are another long-term cost resulting from federal operations that are not reflected in the budget. These costs have only been recognized in the budget to the extent that appropriations have been provided for specific cleanup work. Under federal accounting standards, environmental cleanup costs are reported as a liability on the financial statements. Recognizing in the budget the new environmental cleanup costs resulting from the government's activities during the year would provide a truer representation of the commitments that the government has made.

[11] *Budget Issues: Budgeting For Federal Insurance Programs* (GAO/AIMD-97-16, September 30, 1997) and *Budget Issues: Budgeting For Federal Insurance Programs* (GAO/T-AIMD-98-147, April 23, 1998).

Some Long-term Commitments May Need to Be Addressed in an Innovative Way

Some in the United States are interested in improving the budget recognition of long-term commitments, such as those associated with large social insurance programs, and may think that accrual budgeting would help. However, as implemented by the case study countries, accrual budgeting does not address these commitments. In general, the countries chose to mirror their financial accounting standards in their accrual budgets. Even though social insurance is largely viewed as a government commitment that may result in future cash outlays, it is not judged to be a liability based on accounting standards in these countries or in the United States. The standards in these countries generally establish criteria for determining a liability based on whether (1) an event has occurred, (2) a future payment is probable, and (3) the amount of the future payment is reasonably estimable. Since social insurance is not judged by accountants as meeting these criteria, none of the case study countries have budgeted for such commitments on an accrual basis. This would also be the case if the United States adopted accrual budgeting based on current federal accounting standards.[12] The appropriate treatment of these types of long-term commitments in financial and budgetary reporting remains a challenge.

For these commitments, it may be useful to consider alternative approaches that deviate from financial accounting standards but still recognize costs sooner than would be the case under the current cash- and obligation-based budget. For example, annual outlays could be recorded for the Social Security program in the same amount as the annual receipts. This would eliminate any annual surplus and recognize that at least the amount paid into the trust funds will be spent on Social Security. Alternatively, budget recognition of receipts might be deferred until the receipts are used to make payments in the future. Under these two options, the current cash surplus in Social Security projected to last until 2014

[12]Accounting standards developed for the U.S. federal government do not view social insurance as a liability because the level of future benefits is considered to be uncertain. Proponents of these standards point out that the underlying laws establishing a claim to payments can be (and have been) changed over time. Also, they cite that estimates change greatly depending on economic assumptions and have changed over time. For example, the 1983 legislative changes were expected to maintain a positive fund balance until 2063; however, by current intermediate cost assumptions the fund will run out three decades sooner. However, many others believe that a liability should be recognized for the net benefits expected to be paid in future periods to current participants. The final standard calling for disclosures but not recognizing a liability for such payments was a compromise between the two positions.

would not be recorded as income available for spending. Another possibility would be to present as supplemental information the net present value of the expected cost of the government's long-term commitments in the budget for each budget account or program alongside its cash-based budget authority and outlays. These and other ideas could be explored with the goal of developing a workable concept. Suggestions have been made that a budget concepts commission is needed to address Social Security and other budgeting issues; it could be the proper forum to fully develop new budgeting ideas such as those mentioned here.

Some Country Reforms Emphasize the Need to Better Align Budget and Performance Information to Enhance Accountability for Results

Some countries' reform efforts—particularly those in Australia and New Zealand—emphasize the importance of improving the congruency between the budget and the government's overall performance management and accountability structure. In these countries, the adoption of accrual-based measurement in the budget was combined with a shift to output budgeting.[13] Under output budgeting all the costs associated with producing an output—salaries, depreciation, etc.—are appropriated in a lump sum for the specified outputs. Appropriations are in effect structured around the "price" of various outputs rather than specific budget items such as salaries or equipment. For example, the Ministry of Defence in Australia has one outcome[14] (appropriation) linked to 22 different outputs rather than specific appropriations for personnel, procurement, operations and maintenance, and research and development. Thus, managers have discretion over how to use the appropriation to deliver agreed-upon outputs. Some observers suggested that accrual budgeting alone, while providing a valuable tool to more completely recognize the cost of providing outputs, would not have achieved the same improvements in performance in the absence of this increased managerial discretion. This type of managerial discretion, however, may not be compatible with the U.S. Congress' more detailed control and oversight of spending.

[13]In general terms, output-based appropriations provide funding for the total resources required to produce an "output" (a good or service produced by departments on behalf of the government) including costs that do not require an immediate cash outlay, such as depreciation and pension expenses.

[14]The Australian Department of Defence outcome is "The prevention or defeat of armed force against Australia and its interest." Examples of the associated outputs are "capability for afloat support" and "military geographic information."

In the U.S. context, any potential advantages achieved by changing the budget account structure in this way to appropriate funds for a specific output would need to be considered against the benefits provided by the U.S. Congress' traditional focus on specific spending decisions. For example, appropriation decisions, reinforced by specific accounts, program activity items, and committee report language, allow the Congress more control over specific spending choices. However, in many cases, existing accounts and program by activity schedules do not always provide direct linkages between all of the costs of a specific output and the achievement of that output. Conversely, more performance-based accounts may provide better linkages between spending and results but could result in less detailed information on specific spending decisions. Our previous work further highlights the tension between the objectives of more performance-focused management reforms, such as those required by the Results Act and budget structures that have evolved to help the Congress control and monitor agency activities and spending.[15]

Despite this tension, steps could be taken to further improve links between costs and related performance. Our review of agencies' performance plans shows that some agencies have been able to develop approaches that make basic and useful connections between proposed spending and expected performance. Further, it may be possible to develop mechanisms that achieve better matching of budget costs and performance without forfeiting up-front budgeting controls. For example, capital acquisition funds (CAF) could better match an asset's cost with its use in the provision of goods and services while preserving up-front funding control. Under this type of mechanism, a CAF could be created for each department to purchase all of the department's assets. It would have authority to borrow[16] from the Treasury[17] to purchase federally owned assets needed by sub-components of the department. These sub-components would then "rent" the assets from the CAF, paying sufficient rent so that the CAF could repay both the principal and interest on the Treasury loan. Because the interest

[15] *Performance Budgeting: Initial Agency Experiences Provide a Foundation to Assess Future Directions* (GAO/T-AIMD/GGD-99-216, July 1, 1999).

[16] Authority to borrow refers to the statutory authority that permits a federal agency to incur obligations and make payments to liquidate obligations out of borrowed monies. This does not include the Treasury's authority to borrow from the public or other sources under 31 U.S.C. 31.

[17] Authority to borrow is a type of budget authority and thus is subject to congressional control.

on the Treasury loan is included in the rent, the cost of using resources to purchase the asset would be reflected in the agency's budget. Thus, the cost appearing in the sub-components' budgets—the rent paid—represents both the asset cost and the cost of the capital used in the provision of goods and services. This type of mechanism is one way that accrual-based cost could be incorporated in the budget at the agency level while preserving the cash and obligations basis for the government as a whole.

Both the experiences of the case study countries and our previous work highlight the need for continued efforts to improve the role of the federal budget in addressing the performance and sustainability of government activities as well as accountability for decisions made. To varying degrees, the case study countries have used accrual concepts within the budget as a tool in addressing these issues. As in these countries, the degree to which accrual concepts are integrated into the U.S. federal budget should reflect the government's fiscal control and managerial objectives.

Thus, to be most useful, the ideas drawn from other countries' experiences with accrual budgeting must be considered in the context of the U.S. government's institutional structure. For example, the selective use of accrual measurement in the budget may be used to recognize the cost of decisions whose cash consequences may not occur for years while preserving the up-front control of obligation-based budgeting. The development of mechanisms such as CAFs as well as continued work to better align the program and activities structures, which form the basis for agencies' budget requests, with performance goals could support the emphasis on performance-driven management envisioned under the Results Act while recognizing that the current budget account structure evolved at least in part from the Congress' desire to ensure detailed accountability over spending decisions.

Conclusions

The United States can benefit from the experiences of countries that have adopted accrual budgeting. However, for several reasons, the wholesale adoption of accrual budgeting in the United States may not garner the benefits cited by other countries. First, some countries combined accrual budgeting with broader management reforms, including substantial shifts in authority and accountability to executive agencies; thus, the benefits they cite cannot be solely attributed to accrual budgeting. Second, the up-front control of the U.S. obligation-based budget provides important accountability within our institutional framework of government to meet the needs of both the Congress and the President in addressing their unique

accountability for fiscal policy and budgetary outcomes. In addition, many of the one-time benefits, such as the identification of assets and liabilities, already have begun to be addressed by the CFO Act and other reforms. Finally, the size and complexity of the U.S. government's activities suggest that it would face implementation challenges similar to, if not greater than, those faced by case study countries.

The challenge is how to translate useful ideas developed in one political system to the United States' system in ways that improve its decision-making process while protecting its unique institutional needs. Recognizing the unique role of the Congress in the budget process, accrual concepts can be selectively applied to strengthen the capacity of the Congress and the President by prompting greater information and accountability for the costs of commitments extending into the future. While the United States' obligation- and cash-based budget serves well in most areas, it could be improved by selectively incorporating some accrual concepts to better recognize costs of certain commitments. In addition, explorations of accrual concepts different from those embodied in accounting standards could very well lead to new ways of budgeting for long-term commitments. While accrual budgeting, in its purest form, applied to capital would serve to weaken accountability for the costs of commitments, other approaches can be explored.

In considering potential reforms it is also important to recognize that the timing of cost recognition, that is, cash versus accrual measurement, is but one of several factors that shape the budgetary information and incentives provided to decisionmakers. Although accrual measurement may result in more timely budget recognition for some items, this change alone will not be sufficient to improve budget information. Decisionmakers also need information with sufficient breadth to adequately assess the relative contribution of multiple programs and various tools—such as spending and tax expenditures—to carry out common federal missions. The development of a broader and more integrated budgetary framework is particularly important for crosscutting areas, such as health care or the antiterrorism effort, which may involve both tax incentives and an array of programs carried out by numerous agencies. More fully integrating longer term analyses, such as the use of net present value calculations, into the budget process may also be useful in helping decisionmakers understand the future implications of current policy decisions. Some case study countries' experiences suggest that there may be value in using multiple measures to assess fiscal and managerial performance. Thus, accrual budgeting is just one of a number of tools and approaches that the United

States should consider as it works to improve the role of the budget in addressing concerns about public sector performance, the sustainability of government activities, and accountability for results.

Matters for Congressional Consideration

As the Congress considers changes in the budget structure and/or process, it would be well served to explore ways to improve information on two dimensions: breadth and time horizon. This report dealt with one way to lengthen the time horizon for information. The Congress should consider the selective use of accrual measurement in the budget in areas where it would enhance obligation-based control. In addition, the Congress and the Office of Management and Budget should consider whether and when to use mechanisms, such as capital acquisition funds, to better match budget recognition with the consumption of resources while preserving up-front control.

Commonwealth of Australia

Australia's shift to accrual reporting and budgeting has progressed over several years, along with a series of broader reform efforts aimed at improving service delivery, fiscal position, and public sector performance. The shift to accrual budgeting was undertaken to ensure a better link between budgeted information and actual performance. A unique aspect of Australia's accrual budgeting, reporting, and accounting framework is that it seeks to both link outputs and outcomes through a strategic planning process and to hold managers accountable for outputs. The shift is also intended to increase transparency and accountability of public policies through greater consistency of information and, ultimately, through benchmarking of public activities against similar activities in the private sector.

Background

The Commonwealth of Australia is a federation composed of a national government, 6 state governments, territories, and hundreds of local government bodies. The legislative power at the national level is vested in the Commonwealth Parliament, made up of the House of Representatives (148 members) and the Senate (76 members—12 from each of the 6 states and 2 from each of the two most populous territories). The party or coalition of parties with a majority in the House of Representatives forms the government and provides the Prime Minister. The Prime Minister and Cabinet form the Executive Government of the Commonwealth. Cabinet members are selected from both the House and the Senate.

The two largest political parties in the Commonwealth Parliament are the Australian Labor Party and the Liberal Party of Australia. The other parties are the Australian Democrats, the National Party of Australia, and independents. The Labor Party was in office from 1983 through 1996, after which it was replaced by the Liberal-National Coalition.

The Commonwealth government collects more than 70 percent of the public sector revenue but is responsible for just over half of public sector expenditures—the remainder is transferred to lower levels of government. Commonwealth budget responsibilities include national defense, immigration, outpatient services and pharmaceuticals, social security and welfare,[1] and others. State responsibilities include most public sector spending on education, hospitals, public safety, and infrastructure. Local responsibilities include local roads and parks, libraries, and land-use planning. Commonwealth revenue comes primarily from income taxes, sales taxes, and custom and excise duties. State revenue comes mainly from payroll, business franchise, and stamp taxes, as well as Commonwealth transfers in the form of general and specific purpose grants, and a national goods and services tax which will go into effect July 1, 2000. Local government revenue comes from property taxes, charges, fines, and a portion of the Commonwealth grants to the states.

The Budget Process

The governing party or coalition of parties in power has control over the entire budget process. The government, through the Department of the Treasury and the Department of Finance and Administration (DoFA), prepares the budget for presentation to Parliament. The budget contains estimates for the current budget year, which runs from July 1 to June 30, and projections for the 3 forward years. The process starts with senior ministers setting overall fiscal strategy and policy and defining government priorities for the Budget. A subgroup of the Cabinet called the Expenditure Review Committee (ERC—which is chaired by the Prime Minister, or in the Prime Minister's absence by the Treasurer) sets outlay targets[2] and examines all expenditure proposals in the light of the government's strategic fiscal policy framework. Cabinet ministers advocate for new programs (new outputs in the new framework) or increased funding (increased prices for outputs in the new framework) before ERC, which reviews and recommends to the Cabinet those programs that promise to

[1]The term social security and welfare refers to old-age pensions, unemployment benefits, and welfare. Old-age pension payments are funded out of the general fund, with neither employers nor employees making contributory payments. Unemployment benefits are also funded out of the general fund, and there is no separate unemployment insurance fund.

[2]Outlay targets are set using a system of forward estimates, which are outlay estimates based on decisions made in the previous budget year with no future policy changes—similar to the "baseline" in the United States.

fulfill Cabinet priorities. There is a separate Revenue Committee of the Cabinet to consider revenue measures.

Budgets are passed largely intact by the House, as the majority of members are from the same party, or coalition of parties, as the Executive Government that developed the budget. The Australian Constitution prevents the Senate from amending appropriation legislation relating to "ordinary annual services" of the government, as opposed to its other activities. In 1965, the Executive Government and the Senate entered into a compact to distinguish between "ordinary annual services" and other funding requests. Appropriations for "ordinary annual services," which under the new framework includes replacement capital, are presented in Bill 1, which the Senate must pass or reject in total.[3] Bill 2, which contains requests for spending on new outcomes or capital projects, can be changed by the Senate.

The Economy and the Budget

Australia's economy grew quickly in the late 1980s, spurred by strong growth in exports, consumption, and high business investment. However, in 1991 Australia entered a recession. The economy began to recover in 1992, and since then Australia has experienced a period of sustained growth in gross domestic product (GDP) averaging about 4 percent per year, compared to an annual average of over 3 percent in the 1970s and 1980s. Australia's GDP growth in the 1990s has come with lower inflation than in the previous two decades. Despite a drop in the unemployment rate from a peak of almost 11 percent in 1993 to just below 7 percent by the end of 1999, inflation has averaged around 2 percent annually since 1993. In the 12 months ending September 1999, GDP growth remained strong at 3.9 percent, despite an economic crisis in much of Asia.

[3] If the Senate does not pass the government's budget, a new general election may be called. In 1975, a "double dissolution" of the Labor government under Prime Minister Whitlam and the sitting Parliament occurred after the Senate twice refused to pass the appropriation bills for government's "ordinary annual services."

The Commonwealth has experienced two periods of budget surpluses since the mid-1980s, both preceded by periods of deficits and deficit reduction. The first surplus period started in fiscal year 1987-88 and lasted through 4 fiscal years. Deficits reemerged in 1991 primarily as a result of the recession. In 1996, a newly elected government embarked on a renewed deficit reduction effort that culminated in underlying budget surpluses since fiscal year 1997-98, measured on a new definition of fiscal balance.[4]

Recent Reforms

Over the past two decades, the government instituted numerous management and budgetary process changes aimed at making delivery of government services more efficient. These reforms sought to highlight budgetary decisions, thus making them more transparent.[5] Reforms continued in the latter half of the 1990s when the government introduced the Charter of Budget Honesty to further improve fiscal performance through increasing transparency and accountability of fiscal policy. Following a comprehensive review of government operations conducted in 1996 by the National Commission of Audit (NCOA),[6] the new public sector reform agenda emphasized (1) putting the public sector on a more businesslike footing, (2) fostering a more competitive environment, and (3) building a performance culture. The Financial Management and Accountability Act 1997 introduced devolution of greater responsibility for Commonwealth financial administration to departments and agencies, along with the means with which to hold chief executives accountable for exercising their management prerogatives. An accrual-based, resource

[4]The term surplus/deficit can refer to three measures of budget balance. Prior to fiscal year 1996-97, it referred to the headline cash balance, measured as the difference between revenue and cash outlays. Beginning in fiscal year 1996-97, the measurement of the surplus/deficit changed from a headline cash basis to an 'underlying cash' basis, which excludes the net effects of advances, loans, and equity transactions such as sales and purchases of capital assets. If a headline cash measurement is used, Australia achieved a small surplus of about one-half percent of GDP in fiscal year 1996-97. Beginning in fiscal year 1999-2000, with the implementation of the new accrual budgeting framework, the fiscal balance has been adopted as the new measure of fiscal position.

[5]The reforms can be sorted into two broad initiatives—the Financial Management Improvement Program and Program Management and Budgeting. Reforms restructured departments into portfolios, introduced budgeting using forward estimates over a 3-year period, and required that departments provide an "efficiency dividend," i.e., budget savings, through increased efficiency.

[6]NCOA was established by the government in March 1996 to review and report on the state of fiscal position and to advise the government on the management of its finances in order to improve Australia's medium- and long-term fiscal position.

management framework that integrated budgeting, reporting, and accounting on the same basis was seen as the tool that would allow the government to move closer to its goals of efficiency, transparency, and performance management.

Use of Accruals in Financial Management

Australia has progressively extended the use of accrual accounting across government, first requiring audited financial statements at the departmental level, then recommending audited whole-of-government reports, and finally budgeting on an accrual basis. The progressive application of accrual in government came about as decisionmakers in both the executive and legislative branches became increasingly convinced of the need for better alignment between budgeted amounts and financial information on actual performance.

Implementation Timeline

Australia extended the use of accrual accounting progressively across government by making continual modifications to cash reporting and improving the reporting of assets and liabilities. In the early 1990s, as the government increased the use of contracting out for services, managers' needs for new information to better price goods and services, manage assets and liabilities, and administer contracts, spurred the search for new ways to measure the costs of performance. By fiscal year 1994-95, departments had fully transitioned to reporting their operations on a full accrual basis and publishing financial statements, which are audited by the Australian National Audit Office (ANAO).[7] For the year ending June 30, 1998, the Commonwealth government as a whole received an unqualified audit opinion on its financial statements.

In April 1997, the government agreed to the implementation of accrual-based outcome and output budgeting for the fiscal year 1999-2000 budget. By November 1998, all departments and agencies had agreed with their ministers on the desired outcomes and the contributing outputs to achieve those outcomes. In the first part of 1999, departments and agencies assigned accrual-based prices to those outcomes. The fiscal year 1999-2000 budget, tabled in May 1999, was the first budget to implement the full

[7]The Auditor General Act 1997 grants to ANAO the ability to conduct financial statement and performance audits of Commonwealth agencies, authorities, and owned and controlled companies. ANAO also provides professional advice and assistance in relation to auditing and accounting matters generally with the emphasis on practical guidance.

accrual-based outcomes and outputs framework including accrual budgets and accrual reporting. Though this budget expresses funding in accrual terms, it is still considered transitional because it allocates funding to departments based on the full accrual expenses of department inputs necessary to provide the outputs that the government plans to contribute to the achievement of outcomes that the government has decided to fund. The Australian model seeks to move departments and agencies to a system where they will justify the price of their outputs as far as possible by comparison with other suppliers. Officials informed us, however, that it would take a few years before they could successfully determine proper benchmarked prices.

Factors Driving Adoption of Accrual Budgeting

The adoption of accrual budgeting was spurred by recommendations from both a parliamentary committee and a government commission. In 1995, the Joint Committee on Public Accounts (JCPA) endorsed the preparation of audited consolidated financial statements for the government beginning with the 1997-98 financial year.[8] The committee further suggested that the Commonwealth adopt accrual budgeting once the first audited whole-of-government financial statements were tabled in Parliament.

In 1996, the NCOA recommended an integrated resource management and accountability framework that would focus explicitly on outputs and outcomes, identify the full cost of resources consumed by a program, and facilitate the competitive tendering and benchmarking processes. In an assessment of government operations and fiscal position, NCOA noted that the existing financial management information systems maintained for budget formulation purposes were predicated on the need to provide the government with forward estimates through a sophisticated but still cash-based system. While all Commonwealth entities were required annually to table audited financial statements prepared on an accrual basis, NCOA found that few had implemented accrual standards in such a way as to enable them to budget, track, and manage their programs based on a knowledge of their full costs. Proponents of NCOA's framework believed that by putting the onus on departments and agencies to manage on a businesslike footing, the new accrual-based, resource management framework would force greater attention on cost data.

[8] *Financial Reporting for the Commonwealth: Towards Greater Transparency and Accountability,* Parliament of the Commonwealth of Australia, Joint Committee of Public Accounts, Report 341, November 1995.

NCOA also determined that an accrual framework would support the accountability needs of the public and Parliament by increasing transparency and comparability in the government's financial activities at the departmental, aggregate budget, and whole-of-government levels. According to finance officials we interviewed, accrual budgeting was grounded in the belief that in order to be useful, the costs of expected and actual performance should be budgeted and reported on the same basis. Applying consistent standards to the accounting of various items, such as purchases and sales of physical assets, enables better comparisons between (1) the costs of expected and actual performance, (2) the total costs accruing to different departments delivering similar outputs, and (3) the costs of public versus private sector provision of services. Consistent information is also crucial to the appraisal of performance in an environment of devolved responsibility where executives and managers are given discretion to determine how and by whom services are delivered and how operations are financed and organized.

NCOA's findings and recommendations found resonance among some members of Parliament who had voiced concerns that the disconnect between budgeting and financial statement reporting discouraged the use of financial statement information for decision-making. Additionally, these parliamentarians believed that continued existence of a cash-based budgeting system would impede the acceptance of accrual accounting and reporting in government departments and create confusion for those trying to monitor the financial position of government. Finally, cash budgeting was perceived as failing to effect the behavioral changes necessary to achieve better and more efficient government.

Once the government decided to adopt accrual standards for budgeting, it also determined that the budget should follow all applicable accounting standards developed by official standard-setting bodies.[9] The 1999-2000 budget was reported against two accrual standards. The first, the Australian Accounting Standard No. 31 'Financial Reporting by Government' (AAS31) is the relevant accounting standard for financial

[9]In Australia, there are two important accounting standard-setting bodies. The Public Sector Accounting Standards Board (PSASB) was established in 1983 to formulate, develop, and maintain reporting standards of relevance to public sector entities. PSASB works closely with the Australian Accounting Standards Board, which is responsible for developing standards for private companies, to jointly develop and promulgate Statements of Accounting Concepts and Australian Accounting Standards that are applicable to both the public and private sectors. It is planned to merge the two boards during the year 2000.

reporting by governments. The second, the Australian Bureau of Statistics' accrual-based *Government Finance Statistics* (GFS) standard is consistent with international standards used by the International Monetary Fund and the United Nations. In areas where departures from applicable standards were necessary—for example, the budget covers the general government sector instead of the whole-of-government sector covered by financial reporting—the budget documents identify these exceptions.

Summary of Accrual Budgeting System

Australia's accrual-based model of budgeting sought to change appropriations from a cash to an outcome-output framework, with outputs priced on an accrual basis and tied to the achievement of outcomes. While the old cash-based budgeting framework focused on measuring inputs and monitoring outcomes, the links between inputs and outcomes have often been unclear. The new accrual framework seeks to address this problem by switching the focus from measuring inputs to measuring outputs, thereby achieving a more direct link to outcomes.

Under the new accrual budgeting framework, departments work with their ministers to specify both outputs and outcomes. Specification of output requires the identification of the price of output and other key attributes, such as quantity and quality, whereas specifying outcomes involves providing performance information on the achievement of planned outcomes and the contribution of outputs to those outcomes. Under this new model, departmental executives are held accountable for the delivery of both outputs and the contribution their agencies' outputs make to the achievement of outcomes. This approach differs from the New Zealand model. While under the Australian model, ministers are responsible for defining outcomes and for ensuring that outputs to be supplied by departments produce those outcomes, the New Zealand model holds departmental executives responsible only for the delivery of outputs, and not outcomes.

The new accrual framework also changes the primary measure of the fiscal position from an underlying cash balance—net of advances—to what is referred to as a fiscal balance. The fiscal balance, like the underlying cash balance, measures the government's contribution to net lending (the national investment/saving imbalance) and hence to the external current account balance. Fiscal balance is a measure in the GFS operating statement. Since the measure is consistent with GFS standards and concepts it is also consistent with international standards. However, it can also be derived by making adjustments to the standard operating result.

Figure 3 illustrates the translation from the accrual-based net operating result to the fiscal balance.

Figure 3: Reconciliation of the Accrual Operating Result to the Fiscal Balance

Operating Result
+ revaluations/writedowns from superannuation
+ net writedown of assets
+ net foreign exchange losses
+ other economic revaluations
-/+ profit/(loss) on the sale of assets
- cost of asset sales

= **Net Operating Result** per Australian Bureau of Statistics Standards (Saving Proxy)
- purchase of property, plant, equipment, and intangibles
- assets acquired under finance leases
+ proceeds from sales of property, plant, equipment, and intangibles
+ depreciation and amortization

= **Fiscal Balance**

These adjustments bring the operating result to a measurement closer to net lending. For example, purchases of property, plant, and equipment are subtracted from the operating result while proceeds from sales of property, plant, and equipment are added to the operating result. Officials in Australia argued that a measure that approximates net lending (rather than the operating result) ensures consistency with the National Accounts concepts, thus allowing a more ready assessment of the budget's impact on the economy. As we reported in our previous work, Australia's fiscal policies have been developed largely in response to concerns over low national saving and high net foreign debt and their impact on Australia's international competitiveness.[10] This is consistent with the United Nations' System of National Accounts 1993. In the same manner, the fiscal balance measures the government's net lending and hence its contribution to, or detraction from, the private saving pool. In this area as well as in its focus on outcomes, the Australian accrual model differs from New Zealand's in that Australia puts more emphasis on retaining a net lending measure of

[10] *Budget Surpluses: Experiences of Other Nations and Implications for the United States* (GAO/AIMD-00-23, November 2, 1999).

fiscal position whereas New Zealand uses the accrual operating result as a primary measure of the impact of its fiscal policies.

At a broader level, officials we spoke to considered the main advantage of accrual measures (as opposed to cash) to be a more comprehensive indication of the total activity of government and the long-term effects of current policy. They also suggested that cash measures do, however, have some advantages for tracking expenditures in a fiscal year and helping to identify the short-term effect of fiscal policy on the economy. Consequently, cash indicators for the headline and the underlying balance will continue to be produced.

Structure of Appropriations

Figure 4 shows the financial statements used in presenting the Commonwealth's fiscal year 1999-2000 budget. The first three financial statements are similar to the primary financial statements used in the private sector and are based on Australian accounting standards.[11] The government also submitted a fourth statement, the capital budget statement, to present information on capital transactions.[12]

[11]The fiscal year 1999-2000 budget was prepared in accordance with applicable Australian Accounting Standards (AAS) with several exceptions. First, the budget covers the general government sector instead of the whole-of-government sector covered by AAS. Second, dividends are recorded in the year declared instead of in the year earned. Third, taxes collected on behalf of others are not recognized in the budget. Fourth, revenue is recorded on a different basis as explained in a later section.

[12]The Capital Budget Statement includes information on all capital expenditures, which may be funded by the internal funds of each department—i.e., cash from operations, cash appropriations made by the government in previous years, and sales of agency assets—and/or from capital injections and loans. This statement is different from Appropriations Bill 2, which covers only projects requiring capital injections or loans.

Figure 4: Financial Statements Used to Represent the Government's Budget

The accrual-based budget is represented by four statements at the agency and whole-of-government levels:

- **a budgeted operating statement** identifies the revenues to be generated and expenses incurred during the reporting period and any differences therein;
- **a budgeted balance sheet** reports on the estimated assets and liabilities of the government and provides information about the resources controlled by and the obligations of the government;
- **a budgeted statement of cash flows** indicates the sources of cash inflows and how cash was to be applied by agencies during the financial year; and
- **a capital budget statement** gives detailed information on all capital acquisitions, which includes those that require equity injections or loans, and thus an appropriation from Parliament, and those that are to be funded from accumulated depreciation and therefore do not require an appropriation.

Appropriations for each department or agency are for the financial resources, measured on an accrual basis, required to produce outputs that contribute to government outcomes. The output-outcome structure is determined through the strategic planning process, in which departments and their ministers first define desired outcomes, then define the outputs that, if delivered, would lead to the achievement of those outcomes. Appropriations make a differentiation between departmental items (controlled by departments) and administered items (where departments have no discretion and where expenses arise when recipients meet eligibility criteria, e.g., loans and social security payments). Appropriation Bill 1 includes recurring departmental and administered items. Appropriation Bill 2 includes requests for capital injections and funding for new outcomes.

Treatment of Specific Budget Items

Budgeting and reporting in Australia follow accrual accounting standards. This means that assets are capitalized and depreciation expense recorded over the life of the asset. Liabilities are recorded when they are incurred, as follows:

- **Public sector employee pension**: Under accrual budgeting, departments pay into a centralized pension fund an amount equal to the

public pension accruing to current employees, as well as the interest on or any changes in the outstanding liability due to past services rendered. Generally, changes in the value of the outstanding liability occur as a result of revaluation in the number of salary earners and assumptions relating to wage growth, inflation, and the expected rate of return on investment. The public pension expense is booked as a departmental expense on the department's operating statement, incorporated into the prices of outputs, and thus included in the department's request for funding. The centralized pension fund records these contributions as revenues and uses cash received to make payments to current retirees. At the end of the year, the central pension fund books an actuarial liability in the whole-of-government financial statements.

- **Capital**: Under accrual budgeting, the annual cost of using capital assets, namely depreciation and a cost-of-capital charge, is recorded in the operating statement and thus incorporated into the cost of the departments' outputs. The departments receive appropriations for these noncash expenditures. The cost-of-capital charge is funded based on the beginning asset balance and repaid to the government based on the ending asset balance. Managers have the freedom to optimize their asset base, which includes purchasing replacement assets by using funds accumulated from this depreciation expense. Departments with adequate reserves can purchase assets subject to ministerial approval, which is required even if the proposed purchase is to be financed through a finance lease or other financing arrangement that would not require an immediate cash outlay. Departments with inadequate funds to replace assets have to request a capital injection—an appropriation—for the difference between funds required and available reserves. The cash flow statement will outline most cash outlays for the purchase of property, plant, equipment, and intangibles while the capital budget statement will record total capital expenditures.
- **Inventories**: Departments and agencies can use one of several generally accepted methods for valuing inventory. Expenses are recorded when inventories are used, not when purchased or when the cash outlays occur. Inventory standards apply to only a few departments as most are not accumulating inventories and have no incentive to carry large stockpiles of supplies.
- **Insurance, loans, and guarantees**: Loans are treated as an administered expense and shown on the department's budget as cash outlays when loans are disbursed and cash receipts when payments are collected.

- **Social insurance**: The social security and old-age pension programs are financed from general government revenue. Social security is means-tested and is a supplement to occupational-based pension arrangements. It will continue to operate on a "pay-as-you-go" basis with the budget reflecting the total accrued expense for the current year, even if cash has not been disbursed. Neither the budget nor the financial statements of the government recognize the future commitments of the government. In addition, the government treats the Superannuation Guarantee[13] as general revenue, and does not accumulate it to offset future benefits.
- **Revenues**: Revenue in the budget is recognized when the taxpayer makes a self-assessment or when the Australian Taxation Office or Australian Customs Service issues an assessment. This recognition basis acknowledges that the government cannot reliably forecast or properly value revenues at the time that the economic activity that gives rise to the tax liability occurs. Under the new accrual framework, the government makes an adjustment to receivables to account for uncollectible taxes.

[13]The government requires that employers pay a set percentage of each employee's wage into a superannuation fund, generally private, of the employee's choosing. Consequently, these payments do not affect the government's budget. Employers who do not pay superannuation will pay to the government a fee—the Superannuation Guarantee Charge—equivalent to the contributions (plus interest) that they should have paid directly to a superannuation fund on behalf of their employees.

Aggregate Budget Measure

As shown in figure 5, the government provided several fiscal measures in the 1999-2000 budget: (1) a cash balance (called headline cash balance), (2) an underlying balance (called underlying cash balance), (3) an operating balance (called the operating result), and (4) a fiscal balance. Officials from the Treasurer's Office informed us that while the two objectives of the budget—positively affecting the economy in the short term and focusing attention on managerial issues—are not at odds with each other, they necessitate the use of different measures. They argued that the short-term focus of the former objective is best served when described on a cash basis while the medium- to long-term focus of the latter purpose is best described on an accrual basis. Thus, while the accrual-based operating balance provides information that can be used to address medium- to long-term issues, Australian officials we spoke with felt that a measure that better approximates cash—the fiscal balance—would better assist the government in the conduct of fiscal policies. These officials believed that the fiscal balance, which is derived by making adjustments to the operating balance, is a better indication of the government's contribution to net lending (the national investment/saving imbalance).[14]

[14]The Australian government has repeatedly expressed concern over the low rate of national saving and the country's dependence on foreign sources to make up the difference between the saving rate and the investment demand. Deficit and surplus policies of the Australian government have been articulated within the framework of reducing the government's call on national saving and increasing the government's contribution to net lending.

Figure 5: Measures of Fiscal Position

The **cash balance** measures the difference between the cash receipts and outlays of government transactions.

The **underlying balance** was introduced in 1996 to address the perceived misstatement in the cash balance. Officials found that treating privatization proceeds and loan transactions-where loan repayments were generally larger than loan advances-as cash tended to misstate government finances and represent the fiscal position in a more positive light. The underlying balance excludes balances from one-time transactions, such as state loan repayments to the government and proceeds from asset sales, from the calculation of the fiscal position.

The **operating balance** reports the difference between revenues and expenses using accrual concepts.

The **fiscal balance**, the primary fiscal measure, is derived by adjusting the operating balance to better approximate cash and thus the investment/saving gap. Adjustments are made for revaluation of assets and for large asset transactions, such as purchases of property, plant, and equipment.

Key Differences Between Cash and Accrual

Key differences between accrual and cash amounts occur because of timing. Timing differences mean that the bottom line—the surplus or deficit—is affected in either direction by accrual or cash recognition depending on the activities undertaken by the government in a particular year. This timing difference is most apparent for revenues, asset purchases, public employee pensions, and interest expense. (See figure 6.) For example, cash outlays for the purchase of assets decrease the cash balance in the year the cash is paid under a cash system, but have no effect on the deficit/surplus under an accrual system, as replacement assets will eventually be purchased from depreciation expenses accumulated over the life of the asset. In succeeding years, as the asset is put into service, depreciation expense decreases the accrual-based operating balance, but has no effect on the cash balance. In most instances, because the cash basis tends to recognize large capital items all at once while the accrual basis spreads the cost of purchase over the useful life of the asset, accrual measurements generally smooth out expenses.

Figure 6: Reconciliation Between Operating and Cash Balances

Operating balance (accrual)
+/- Changes in noncash expenses (statement of financial performance):
- + Depreciation expense
- + Provision for bad and doubtful debts
- +/- Reevaluation of assets
- +/- Net losses/(gains) on foreign exchange
- +/- Increase/(decrease) in employee entitlement, (e.g., pension liabilities)
- +/- Losses/(gains) from sale of assets
- +/- Other noncash items (e.g., cost of capital)

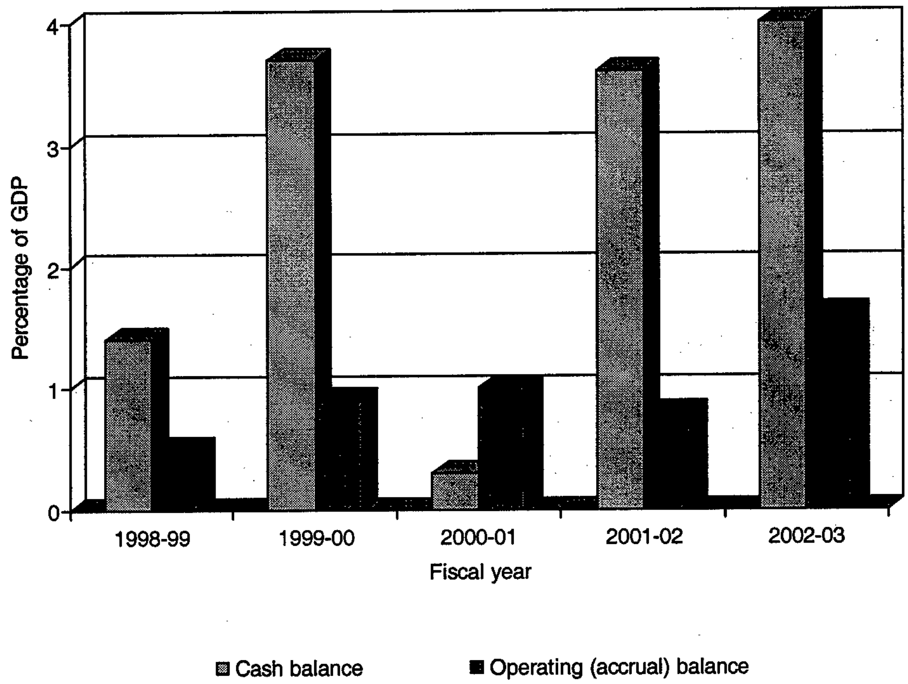
+/- Movements in working capital (statement of financial position):
- +/- Decrease/(increase) in receivable (e.g., revenue, loan receivables)
- +/- Increase/(decrease) in payables
- +/- Decrease/(increase) in other financial assets
- +/- Decrease/(increase) in inventories

+/- Other items
- +/- Sale/(purchase) of assets
- +/- Other investing items

= Cash Balance

Figure 7 shows the differences between the cash and accrual balances as measures of the fiscal position. In the fiscal year 1999-2000 budget, the estimated cash surplus is A$23 billion, compared to an operating surplus of A$5.7 billion, or a difference of 2.8 percent of GDP. The difference is attributed mostly to planned asset sales totaling about A$16 billion. Similarly, in the fiscal years 2001-02 and 2002-03 budgets, planned asset sales are projected to cause the cash balance to be substantially larger than the operating result. By contrast, in the fiscal year 2000-01 budget, the cash surplus is expected to be smaller than the operating surplus due to planned asset purchases.

Figure 7: Estimated Cash Balance Compared to Estimated Accrual-Based Operating Result, Fiscal Years 1998-99 Through 2002-03



Source: *Budget Strategy and Outlook, 1999-2000.*

Views on Implications for Decision-making

The fiscal year 1999-2000 budget is the first accrual-based budget. Consequently, Australia does not yet have any actual experience on which to fully assess its implications for decision-making. Nevertheless, officials and managers we spoke with anticipated that accrual budgeting would bring about better fiscal and managerial decision-making. Officials expect that

- the greater focus on maintaining ongoing budgetary health will result in better decisions that are sustainable in the long run;
- the output and outcome focus will result in greater scrutiny of government objectives and services and lead to improved budget decisions;

- the ability to make comparisons, and ultimately, to benchmark price and performance against private sector entities will spur the public sector towards achieving better results with fewer resources;
- the accrual framework will improve transparency and accountability; and
- the accrual budgeting and reporting framework will bring about better asset management.

Further, NCOA reported that on an aggregate budget level, accrual-based budget projections would provide a more appropriate measure of the ongoing budget balance. By highlighting instances where revenues may not be sufficient to cover all expenses over the forward estimate—even though cash receipts may be available to meet all cash obligations—accrual budgeting helps focus legislative attention earlier if the asset base is being run down or increasing levels of liabilities are being accumulated. With accrual-based projections it also would be possible to see that a projected cash shortfall and a resulting increase in borrowing may be more than offset by an increase in assets and future productive capacity. While the JCPA acknowledged that reporting on a cash basis is simple and that a cash deficit or surplus best captures the net short-term economic impact of the budget, it also argued that accrual budgeting makes possible the assessment of the government's management of its asset base, its liabilities, and its long-term fiscal strength. Further, NCOA noted that accrual budgeting and reporting would not detract attention from cash because the cash flow statement, one of the principal financial statements required by the accrual framework, will provide the cash information.

Accrual-based budgeting is expected to improve effectiveness and efficiency of government programs by centering the budget discussion on what departments and agencies are expected to deliver, i.e., the quantity and quality of outputs rather than inputs. According to government officials, discussions that revolve around outcomes and outputs would necessitate examination of all the costs necessary to deliver those outcomes and outputs. Officials contrasted the new accrual framework to the former cash-based system where departments were guaranteed a budget based on the previous year's costs and the budget debate concentrated only on new spending proposals and saving options—only 3 to 5 percent of the budget. They thought that budget data presented as line-by-line input costs provided a lot of detail without giving decisionmakers adequate information to focus on what the government was doing and whether it was effective. In contrast, officials believed that the outcome and output focus of the new accrual system would shift the budget debate

toward deliberating on the bigger picture, i.e., the objectives of the government and the "totality" of how a department manages its operations and assets.

On the managerial front, officials believed that the new accrual framework would improve incentives to manage better with fewer resources by making it possible to compare performance between government entities and between public and private sector performance. By using a consistent basis to measure the cost of output and eliminating the distortions inherent in a cash system, accrual standards provide an analytical base from which to compare the costs of one department with another. For example, a department would no longer appear more efficient just because it used less cash in a year if, at the same time, it had accumulated more liabilities and consumed more of its asset base. Conversely, a department would not automatically be judged a poor performer because it spent a large amount of cash in one year to purchase an asset, even though the asset would enable it to operate more efficiently in the future. Finally, by accounting on a similar basis as private sector entities, accrual budgeting allows for greater comparability with the private sector. Ultimately, it is hoped that the new accrual system will deliver information so that decisions can be made as to whether a service or good should be purchased from a government department or a private sector entity. Benchmarking, both between departments and against private entities, is an important objective of the Australian accrual budgeting, reporting, and accounting model.

Officials further expected that the ability to retain at least a share of their operating surpluses would lead to better performance by improving management incentives to seek efficiencies continually and improve output delivery, ultimately leading to better outcomes. The government reasoned that withdrawing operating surpluses as they occur or reducing the departmental budget concurrent with the expected efficiency would reduce the incentive to achieve an operating surplus, and, ultimately, the incentive-driven efficiency gains.

Officials believed that standardized and consistent financial information would improve external reporting and facilitate review of government performance, thereby advancing the Commonwealth's agenda of greater accountability and transparency. They pointed at many research findings indicating that reporting information on planned performance on a cash basis and actual performance on an accrual basis through financial statements provided conflicting signals and incentives. Studies also found that managers held accountable for the budget on a cash basis failed to use

financial data in the decision-making process. The government hoped that information consistency would provide for better assessment of planned and actual performance, and, consequently, lead to better results.

Some officials expressed skepticism that financial reporting on an accrual basis necessitates budgeting on that basis. These officials pointed out that the basic budget of the Commonwealth involves handing out cash. Consequently, it makes very little difference whether these transactions are measured on an accrual or a cash basis. However, even these officials conceded that there might be greater potential for managerial improvements. For example, finance officials have repeatedly pointed out serious degradation of physical property at the Federal Airport Authority. However, because of a minor recession in the early 1990s, and because under cash-based budgeting any large cash outlay to address the physical degradation would have a significant impact on one year's fiscal balance, successive governments ignored the need to take actions to improve and maintain the asset base. As it now prepares for privatization of the entity, Parliament finds that the degradation is so serious that it needs to spend A$100 million just to be able to sell the property. NAO officials speculated that, had accrual accounting standards been in place that allowed for the capital spending to be spread over the life of the asset, instead of a cash budgeting system where the entire amount of the spending needed to be recognized at the time the cash was disbursed, decisionmakers might have taken earlier and more timely actions. Ultimately, accrual budgeting may help address the tendency under accrual financial reporting to maintain and manage to a cash-based system and then use adjustments at the end of the accounting period to construct general-purpose financial reports.

Proponents expect that clearer distinction between capital and operating costs will yield important benefits in the area of capital. In the past, capital was not treated consistently. For example, an asset that cost less than A$250,000 might have been treated as an operating cost and included in Appropriation Bill 1—therefore not subject to changes in Parliament—whereas another asset costing the same amount might have been viewed as a new project and submitted as part of Appropriation Bill 2—and so subjected to a higher level of scrutiny. In the new model, all transactions requiring an appropriation in the form of equity injections or loans will appear in Appropriation Bill 2. In addition, the capital budget statement—one of the four primary budget statements—will also include details on every capital project, whether it is to be funded through capital injections or loans, or from departments' accumulated depreciation. Officials informed us that although under the new framework departments will have

flexibility to replace assets through accumulated depreciation, in the beginning departments will not have accumulated adequate funds to replace old assets, much less purchase new assets. Consequently, officials expect that for some period of time, most capital asset transactions will appear in Appropriations Bill 2, which is subject to Senate amendments, and that this will help focus the debate on whether there is a need for new capital spending. In the long run, after these debates have occurred, departments can replace assets out of accumulated depreciation, though they will continue to provide information on their actions through the capital budget statement.

Like other countries that have switched, or are considering a shift, to accrual, Australia also expects better asset management as a benefit from accrual budgeting. For example, the Department of Defence never had an inventory system for consumables such as bullets and ration packs. Accrual accounting requirements resulted in the unearthing of over A$2 billion in inventory. Now, incorporating the inventory costs in the budget will help focus attention on the oversight of these stocks.

As an example of how accrual budgeting provides improved information and incentives that lead to better decisions, Treasury officials pointed to the resolution of what, until recently, was the difficult issue of retiring debt on which premiums must be paid or discounts taken. Under accrual standards, any premium or discount on a particular debt issue is recognized annually, over the life of the issuance. In contrast, the cash system records the full value of the repurchase premium or discount for the year in which the repurchased debt was cancelled or matured. Thus, under cash, retiring debt on which a premium is due—a good thing—could necessitate a cash outlay with a negative impact on that year's bottom line, and was politically difficult to undertake. Under the accrual basis, discounts and premiums are amortized over the life of the debt. Consequently, early debt retirement would have no budgetary impact and could be made based on economic analysis alone.

Parliamentary Accountability and Control

While most parliamentary staff we spoke with were generally supportive of the new accrual framework, questions related to the balance of power and control over spending have arisen within the context of accrual budgeting. They acknowledged that accrual budgets may weaken senatorial power. Under the cash basis, Parliament had to pass appropriation legislation to approve departmental expenditures. The Senate in particular had the authority to make changes to expenditures proposed in Bill 2—principally

capital and new initiatives—and thus could make large amendments to government budget proposals. Under the new accrual framework, once a department receives the authority to purchase an asset, it could continually replace the asset using funds accumulated from depreciation expense, and thus would no longer need Senate appropriation. Similarly, if the department does not intend to purchase new assets from its reserves, it may choose to divert the cash into funding other operating areas. Consequently, the Senate's constitutional authority to express disapproval of the government's budget may diminish because departments can maintain operations while they wait for Senate action on appropriations.

Another concern has been raised over the potential loss of important data that may result in a relaxing of fiscal discipline. Officials informed us that under the cash system, all new capital submissions showed the fiscal impact of these commitments for 10 years or more. While agencies are to continue to submit these estimates, the new capital budget statement provides details only for the budget year and 3 forward years like the rest of the budget. Since the new capital budget statement will be the focus of the budgeting process, ANAO officials we interviewed were concerned that decisionmakers would shift attention towards the shorter-term horizon, which could result in decisions that negatively affect the government's fiscal position. Furthermore, concerns were expressed that there may be an incentive under the new reporting requirement to forgo fiscal discipline. Because the government under the new framework has to recognize only depreciation expense on new capital in the year a new asset is acquired, officials are concerned that the benefits from "announcing" new capital projects would outweigh the costs and result in the acquisition of many new capital projects.

DoFA officials dismissed concerns that appropriating cash for noncash expenses may result in departments diverting available cash into expenses. They were confident that ex-post controls were adequate to monitor the behavior of departments and agencies. While they conceded that no mechanism exists to prevent departments from spending cash that is to be accumulating for depreciation for some other operating expense, such as increasing salaries, such an expenditure would result in an unapproved expense, and therefore a loss on the department's financial statements. Because the DoFA plans to require monthly reporting, it expects that deviations would show up promptly through the routine process of examining departmental financial statements. A loss would be apparent in the analytical process, and would have to be justified to the Minister for Finance and Administration.

Implementation Issues

At the time of our visit, the departments were in the process of putting together the first accrual budgets. Officials were able to identify several key challenges to implementing accrual, including (1) expanding the skill level, (2) achieving cultural change, and (3) developing adequate accounting and cost systems.

A senior DoFA official said that improving the accounting skill of budget staff accustomed to operating within a cash environment is crucial to ensuring the smooth transition and implementation of accrual budgeting. The department took a survey to assess the accounting skills that already existed at the other departments and highlighted those skills that needed developing. Although individual departments had to assume the responsibility for ensuring that budget and other personnel were properly trained, DoFA worked with various consultants to develop a training strategy to build up the skills necessary to adopt to the accrual reforms.

Cultural change was and continues to be a key challenge. DoFA officials spearheading the switch to accrual budgeting informed us that ensuring cultural change was a necessary ingredient to a successful transition. Eighteen months ago, DoFA started to address this need by convening representatives from every department so that they could better disseminate information related to the new accrual framework. The group served to raise awareness within departments that a change was going to take place and helped develop an openness and receptiveness to change. DoFA officials believed that this approach helped to inform managers and executives of the new budgeting and accounting approach and to generate support and buy-in for the reform.

Finally, a DoFA official identified cost accounting as an area needing extensive attention before the full benefits of an accrual system could be achieved. The shift towards appropriations based on price had created an increased need for cost accounting information, but there was significant variation in the quality of cost information systems across departments and agencies, indicating that this was one area in the public sector that needed greater attention. Improving cost information was viewed as a necessary next step to further financial management and to improve the effectiveness of accrual budgeting and reporting information for performance assessment.

Canada

Over the last 30 years, a series of national commissions have produced studies arguing that the financial management information available to Canadian decisionmakers needed improvement. These studies placed particular focus on the need to collect information on the complete costs of government activities. During the 1990s, the government proceeded with plans to improve the quality and quantity of financial information. In 1995, a decision was made to produce audited financial statements, on a full accrual basis, for the whole-of-government by fiscal year 2001-02. The decision regarding how to maintain the alignment between the financial statements and the departmental appropriation requests was deferred at that time. Recently, parliamentary committees and the Auditor General's office have recommended changing the appropriations request to a full accrual basis to be consistent with the financial statements.

Background

Canada is a federal system composed of a central government, 10 provincial governments, and three territories.[1] All of these governments are parliamentary systems. The federal government is composed of a Senate and a House of Commons. Members of the House of Commons are elected by popular vote, at least every 5 years, while senators are appointed by the Governor General on the recommendation of the Prime Minister. While the House of Commons is the main law-making body, no bill can become law unless it has been passed by the Senate. In general, the political party with the majority of seats in the House of Commons usually forms the government and the leader of this party becomes the Prime Minister.

Governmental Structure

The current Prime Minister, Jean Chrétien, became Prime Minister in 1993 when the Liberal Party regained a majority in the House after 9 years of Progressive Conservative Party rule. In June 1997, the Liberal government was reelected, winning 155 of 301 seats in the House. Throughout most of this century, the Liberal Party and the Progressive Conservative Party have dominated Canadian federal politics. Currently, however, the Reform Party has the second largest number of seats in the House at 59. The remaining seats are divided among the Bloc Québecois (44), the New Democratic

[1]Each provincial legislature is composed of a single house that is elected by popular vote. Provincial premiers are the leaders of the parties that hold majorities in the provincial legislatures. In addition, provincial legislatures may set up municipal governments, giving them powers as they see fit.

Party (21), the Progressive Conservatives (19), and independent members (2).

Executive authority at the federal level resides in the Prime Minister's Cabinet. The Prime Minister chooses Cabinet ministers from members of Parliament in the governing party. The Cabinet is responsible for most legislation; it develops government policy and is responsible to the House of Commons. The federal government has explicit responsibility over national defense, interprovincial and international trade and commerce, immigration, the banking and monetary system, and criminal laws. Provincial governments are responsible for education, property and civil rights, the administration of justice, the hospital system, natural resources within their borders, social security, health, and municipal institutions. All powers not specifically conferred upon the provinces are assigned to the federal government.

The Budget Process

In recent years, reforms have been undertaken to make the Canadian federal budget process more open. In response to criticism of the closed nature of the budget process, the government began to move towards greater openness in 1994. In the fall of 1994, the government began releasing annual midyear fiscal updates that contain deficit/surplus targets and an economic update. In addition, after release of the midyear updates, a series of consultations about the next year's budget have been held with members of Parliament and the public. Several officials we interviewed said that the prebudget consultations allow the government to put forward some of its ideas for new spending and tax initiatives and receive feedback prior to release of the Budget.

The Cabinet has the sole power to prepare and introduce budget-related bills. In general, neither the House nor the Senate may increase taxes or expenditures.[2] The government, led by the Ministry of Finance, prepares its budget, which is tabled in, or presented to, Parliament. The government's budget is tabled in the House of Commons by the Finance Minister, usually in mid-February, giving the government's overall fiscal plan for revenues and expenditures and their relationships to the aggregate measures used to set fiscal targets. In addition, the Budget sets forth detailed spending proposals for the government's new initiatives. The Main Estimates, on the other hand, are the detailed plans for all government expenditures, by department and agency, and are tabled by the President of the Treasury Board Secretariat (TBS) several days after the Budget.[3] The legislation necessary to implement the Main Estimates and Budget are also tabled and are referred to as "money bills." The Estimates are required to be tabled by March 1 and are usually passed before Parliament adjourns in late June. As the fiscal year begins on April 1, Parliament approves an "interim supply," allowing the government to spend the funds necessary for ongoing operations during this period.

The Budget and Main Estimates are neither changed nor debated to any significant degree in Parliament. Failure to pass any of the associated money bills would signal a lack of confidence in the government and almost always lead to new elections. Observers note that this does not mean the government has a free hand. It must consult extensively with Parliament—at least with members of the governing party—prior to introducing any of these bills to ensure passage. Similarly, the government would likely withdraw certain aspects of the budget framework if majority support were not certain.

The Economy and the Budget

During the 1980s and 1990s, Canada experienced two short but severe recessions and two lengthy periods of growth. As a result of the first recession in fiscal year 1981-82, unemployment soared from less than 8 percent in 1981 to nearly 12 percent in 1983. The economy rebounded strongly from the recession, with real economic growth above 5 percent in

[2]Members are allowed to propose a decrease in a tax or expenditure, but such actions are rare.

[3]TBS is an administrative arm of the Treasury Board—a committee of ministers—and provides advice to the board on the preparation of the government's expenditure budget, the monitoring of program spending, and other responsibilities.

both 1984 and 1985. The strong recovery, however, eventually led to inflationary pressures, and the Bank of Canada responded by tightening monetary policy in late 1987. When economic activity slowed in late 1990, the bank began to gradually lower interest rates. However, by 1991, the Canadian economy was again in recession. The unemployment rate rose from about 8 percent in 1990 to over 10 percent in 1991, and remained above 10 percent until 1995. Growth finally began to pick up in mid-1993, was even stronger in 1994, but began to slow again in 1995. In 1997 and 1998, growth picked up again.

After struggling with large deficits for over two decades,[4] Canada achieved a federal budget surplus in fiscal year 1997-98 and expects another one for fiscal year 1998-99. These results reflect several years of significant fiscal restraint, particularly on the spending side of the budget. Such restraint was prompted by concerns that a high and rising debt burden—at both the federal and provincial level—was a major obstacle to the nation's economic future. In response, the federal government's strategy since the mid-1990s has been to reduce the deficit and achieve a balanced budget in accordance with a specific set of fiscal targets. The government has consistently bettered these targets, in part due to its deliberately cautious approach to budget planning. Given this track record, the government's official target of a balanced budget implies a policy of at least modest surpluses. The government recognizes that its cautious planning could result in surpluses by describing its fiscal goal as "balance or better."

[4]For a detailed discussion, see *Deficit Reduction: Experiences of Other Nations* (GAO/AIMD-95-30, December 13, 1994) and *Budget Surpluses: Experiences of Other Nations and Implications for the United States* (GAO/AIMD-00-23, November 2, 1999).

Recent Budgetary Reforms

For more than 30 years, various national commissions have reported on the need to improve the financial information available to key decisionmakers in Canada. The Financial Information Strategy (FIS) was first announced in 1989, and through FIS Canada hopes to achieve improvements in the government's accountability framework as well as efficiencies in program and service delivery. To accomplish FIS' objectives, Canada plans to decentralize many of the financial reporting responsibilities to the departments and to use accrual accounting concepts and new reporting structures to provide departmental managers with better tools for financial management. Under the current financial management regime, financial information is collected, and departmental spending controlled, at the central level by TBS and the Receiver General.[5] In 1995, the Minister of Finance announced the government's decision to adopt full accrual accounting, but set no timetables for implementation. Later that year, TBS adopted a plan to prepare audited financial statements, on a full accrual basis, by 2001. Departmental financial statements must be capable of withstanding the test of audit. At that time, however, a decision on whether to change the departmental appropriation to a full accrual basis was deferred.

In 1996, a parallel reform effort to improve reporting to Parliament was begun. A number of agencies participated in a pilot program to produce Performance Reports in the fall—during prebudget consultations—that present the results achieved by the agencies in accomplishing the plans set forth in the spring in the Reports on Plans and Priorities.[6] Members of Parliament have indicated that having these reports during the prebudget consultative process has proven useful, and the pilot has been extended to all departments. In order to improve the link between the costs of resources consumed and the results achieved in providing a public service, the government has announced its intention to include proposed (budgeted) and actual departmental financial statements on a full accrual

[5]The Receiver General of Canada manages the finances of the Canadian government. It provides banking and cash management services and maintains accounting records.

[6]The government request to Parliament for authority to spend public monies consists of three parts. The Government Expenditure Plan (Part I) and the Main Estimates (Part II) contain financial information. Part III is divided into two parts. The Reports on Plans and Priorities, published at budget time, focus on departmental plans and priorities for the coming year. The Performance Reports in the fall present the results achieved by the agencies.

basis within the Part III Reports on Plans and Priorities and the annual Performance Reports, but did not establish a time frame for doing so.

In 1997, the government announced the Modernization of Comptrollership initiative, a broad reform initiative to improve management in the public sector. The new initiative has incorporated the FIS initiative, which continues to play an integral role in meeting the broader objectives of better financial management. Modernizing Comptrollership takes the theme of decentralization of accountability a step further than FIS by incorporating a human resource component to ensure that managers have the training and skills they need to make decisions in the new environment, a risk management component to provide guidance to managers on how to manage their programs and departments in an environment of scarce resources, and a performance reporting and results initiative to link resources to results. Because these efforts depend heavily on the information provided through accrual accounting, they complement FIS.

In 1998, the House of Commons Standing Committee on Public Accounts argued that to help ensure the success of the FIS Initiative, the government and the Parliament should also appropriate funds on a full accrual basis. It recommended that TBS determine the best possible options to move the appropriations process to a full accrual basis and to report to Parliament regularly on the progress made in developing these options. This recommendation was based largely on the recognition that departmental managers have long been held accountable only through the appropriations process. If funds were appropriated on the same basis as they were reported, the committee believed decisionmakers would make better use of accrual-based information. TBS plans to develop a number of models for consultation with a variety of stakeholders, officials in the Secretariat, staff from the budget and accounting offices in the various departments and program managers.

Use of Accruals in Financial Management

Timeline: Progression of Use of Accruals

Canada was one of the first countries in the world to start moving away from a cash-based reporting system to an accrual basis in its financial statements. A number of significant expenditure items are reported on an accrual basis in the financial statements. For example, public sector

employee pension costs are recorded on an actuarial basis and fully accrued and gains and losses in the pension fund are fully amortized. Furthermore, loans, investments, and advances are subject to an annual revaluation to reflect estimates of changes from carrying value. This allowance for valuation for loans, investments, and advances represents the estimated losses/gains on these assets at year-end. The move to full accrual reporting in the whole-of-government financial statements for fiscal year 2001-02 will most notably include the full capitalization of all assets and related depreciation accounts.

Canada also budgets for some items on an accrual basis. For example, as in the financial statements, the future pension costs for current employees are accrued and included in the departmental budget estimates. Adjustments for the amortization of the net gains and losses are made once the budget is consolidated and not allocated to the individual departments. The budget also includes in the agencies' appropriations request—the Estimates—the expected payment needs for accounts payable.[7] However, financial assets such as loans, investments, and advances are treated as nonbudgetary items[8] and tangible capital is expensed, not accrued. Tax revenues are budgeted on a cash basis but nontax revenues are accrued.[9]

Factors Driving Adoption of Full Accrual Budgeting

Canada appears to have rejected a sweeping approach to public management reforms favoring, instead, more gradual reform. The call for the Estimates to be presented on an accrual basis should be viewed as yet

[7]Accounts payable that are due and payable at year-end are accrued by the government of Canada and charged to its appropriations. A number of liabilities are accrued centrally at year-end that are only reflected in appropriations in the year that payment is made. For example, new spending proposals included in the Federal Budget and meeting the criteria for recognition at year-end would be included in this adjustment. Other liabilities, such as contractual obligations and contingent liabilities, are disclosed in the notes to the government's financial statements and not charged to the deficit/surplus.

[8]Departments are voted authority or have enabling authority to make loans not to exceed an approved book value. In effect, authority is granted to lend but this does not have budgetary impact. While revaluation adjustments at year-end affect annual financial reports, it is only when loans in default are written off that parliamentary appropriations are required and the deficit/surplus is affected. Concessionary loans are made infrequently but require parliamentary appropriations and affect the budget aggregate (deficit/surplus).

[9]Nontax revenues include return on investments such as interest on loans and advances, dividends from investments, and transfer of profits and surpluses and other nontax revenues such as proceeds from the sale of assets, service fees, licenses, permits, etc. Nontax revenues totaled about 6.5 percent of total revenues in fiscal year 1997-98.

another incremental step in furthering efforts to improve financial information available to Canadian decisionmakers. Officials at the TBS and the Office of the Auditor General (OAG) said that once there was a decision to change the accounting treatment for capital, they thought it important to consider changing the budgetary treatment to ensure alignment. Since pensions and accounts payable were already accrued in the budget, tangible capital and tax revenues were the only budgetary items remaining for which cash and accrual treatment significantly differed.

As part of a recent performance audit on the government's FIS initiative,[10] OAG said that by appropriating funds on an accrual basis, the government and the Parliament would strengthen FIS by putting budgetary accountability and reporting on the same basis. The audit found that in implementing FIS, the government had focused its attention on ensuring that departments were implementing their new financial systems and on ensuring that those systems could produce the information necessary to produce the government's annual financial statements. Missing, OAG found, was a plan to make the full accrual financial information available to all managers within departments and agencies, not just those with financial reporting responsibilities. The Standing Committee on Public Accounts concurred with the OAG report and recommended that TBS determine the best possible options for moving the appropriation process to a full accrual basis. Although the process of developing these options is only in its earliest stages, TBS' consultative process has begun in the hopes that it will give stakeholders a better idea of what they are gaining and what might be lost in terms of financial information presented.

OAG also believes that FIS would support the parallel initiative on performance management and accounting for results since it could provide improvements in the government's ability to link costs and results. Similarly, in its 1997 report entitled *Accounting for Results*, TBS said that FIS aims to enhance government decision-making and accountability and to improve organizational performance by providing more complete information on the costs of programs and activities. A senior TBS official

[10]Under the 1977 Auditor General Act, OAG responsibilities were clarified and expanded to include a broad mandate to examine how well the government managed its affairs. The act also gives OAG authority to conduct value-for-money or performance audits. These performance audits help inform legislators on how well the government is implementing its policies and programs. While OAG does not question the merit of a particular government policy, it does help legislators judge how well those policies were implemented and does make recommendations on ways in which implementation can be improved.

told us that the adoption of full accrual accounting for budgeting and reporting is considered a milestone in gaining the ability to fully cost the resources consumed relative to the services provided and results achieved by government programs and activities.

Summary of Accrual Budgeting System

Structure of Appropriations

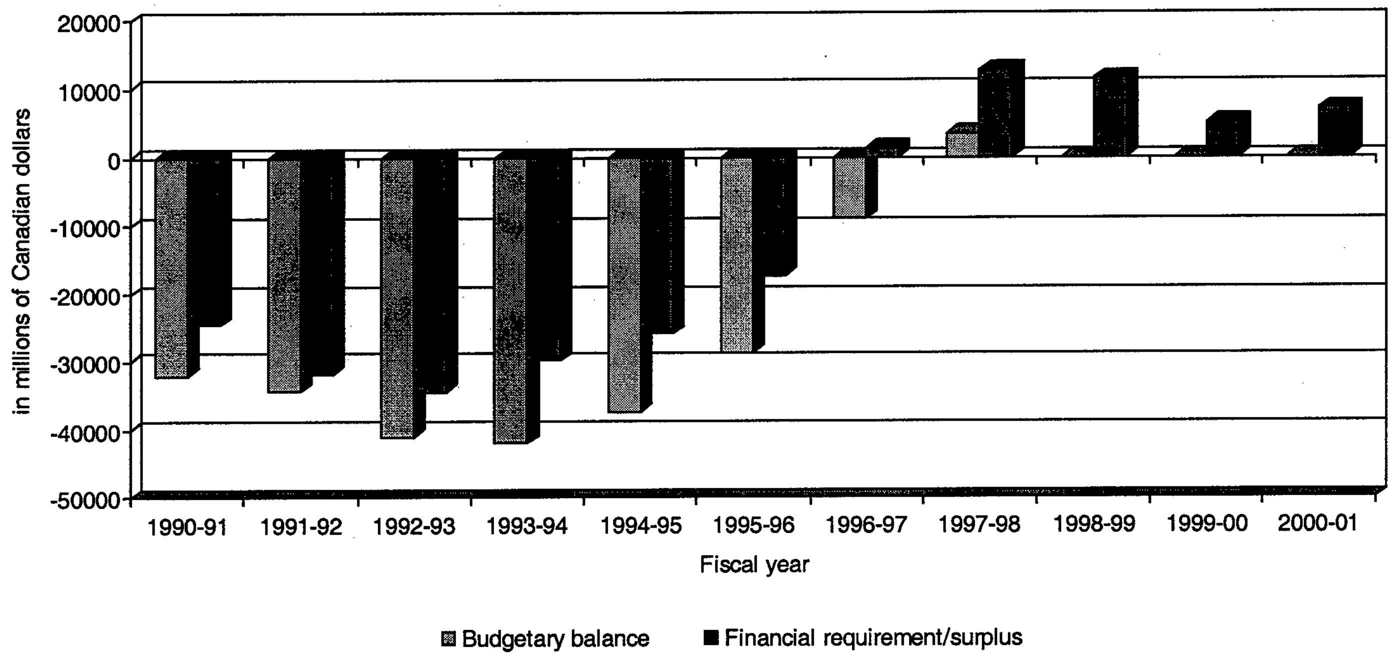
Key issues regarding the structure of accrual appropriations have yet to be resolved. TBS expects that eventually the accrual appropriation model will be represented by the three primary statements found in public and private sector financial statements (1) a Statement of Operations, (2) a Statement of Financial Position (Balance Sheet), and (3) a Cash Flows Statement. If such a format is adopted, votes could be assigned to each department's Statement of Operations and represent approval of the department's projected expenses during the year. Likewise, a vote on a department's Statement of Financial Position would signal approval the department's plans for disposal and acquisition of new capital. Both the Statement of Financial Position and the Statement of Operations would reconcile to the Cash Flows Statement and thus approval of the first two implies approval of the department's cash requirements.

Description of Aggregate Budget Measure

Canada's main measure of the federal surplus/deficit—called the budgetary balance—is calculated on a modified accrual basis which includes the accrued costs of public sector pensions and certain accounts-payable transactions. Canada also reports a cash-based measure or financial requirements/surplus—roughly equivalent to the government's borrowing requirements. In recent years, the financial requirements/surplus has recorded significantly lower deficits or higher surpluses than the budgetary balance (see figure 8). This is largely because public sector pensions and other adjustments are accrued in the budgetary balance while the financial balance is a cash-based amount. The nature of the items accrued in the budgetary balance requires that an expense is recognized in the budget before the cash is needed to pay the expense. Thus, under the government's cautious fiscal policy framework,[11] accrual treatment of these items reduces the resources available for other spending. If accrual budgeting for capital is implemented the opposite would be true. If no adjustments were made to the Estimates for the accrual treatment of capital, the budgetary balance would capture only the annual depreciation charge instead of the cash needed to acquire the asset. The financial balance would, of course, recognize the cash needed to acquire an asset.

[11]The budget seeks to match expected revenues to budgeted expenditures, thus seeking a balanced budget. However, budgeted expenditures include a C$3 billion Contingency Fund that can be used for emergencies while permitting the budget to stay in balance. If no emergency arises, the Contingency Fund will be used to pay down debt.

Figure 8: Alternative Measures of the Fiscal Balance—Budgetary Balance Versus Financial Requirements/Surplus



Note: Aggregate balances for fiscal year 1998-99 are estimates and for fiscal years 1999-00 and 2000-01 are projected.

Source: *The Budget Plan 1999.*

Cash Flows Versus Accrual Operating Balance: Key Differences Between Cash and Accruals

In fiscal year 1997-98, the budgetary surplus was nearly C$3.5 billion—about 0.4 percent of gross domestic product (GDP)—while the financial surplus was about C$12.7 billion. As previously noted, this is largely the result of accruing spending items that require more resources under accrual measurement than would be required if budgeted on a cash basis. Given this pattern, Canada achieved a financial surplus in fiscal year 1996-97—1 year earlier than it reached a budgetary surplus, its primary measure of fiscal position.

Views on Implications for Decision-making

Canada has only started to consider how to develop and present its Estimates on an accrual basis and thus has only begun to address issues relating to the impact this information will have on the budget—the main tool used to develop and implement the government's fiscal policy.

Proponents of accrual budgeting in OAG and TBS believe that the greatest benefits will come as a result of improved managerial decision-making. They base their expectations on the experiences of other countries, such as New Zealand, and certain Canadian provinces, such as Alberta, which already adopted full accrual budgeting. TBS plans to consult with departmental managers as well as with Parliament over the course of the coming months.

Concerns have been raised that the accrual treatment of capital could dilute the meaning of budgetary balance, which has been very important in gaining the public's understanding and support of the current government's fiscal policy agenda. For example, if the budget includes only the annualized depreciation costs, the concept of budgetary balance essentially ignores the means of financing asset acquisition. Critics argue, for example, that if only a fraction of the cost of acquiring an asset is recognized in the budget it could lead to an erosion of the fiscal discipline and adversely affect the debt to GDP ratio—an equally important fiscal target given Canada's high debt levels and debt-service costs. A TBS official believes that the budget presentation formats under consideration will afford sufficient transparency to clearly present planned and actual cash requirements through the Statement of Cash Flows.

Similar unresolved concerns have been raised with respect to capitalizing assets in the financial statements. With the decision to fully accrue tangible capital assets in Canadian governments' financial statements, the Public Sector Accounting Board (PSAB)[12] issued a standard calling for governments to adjust their operating results (revenues less expenses) to reflect the net change in capital assets. This adjustment effectively nets out the depreciation expense charged and adds/subtracts the total value of assets sold/purchased in that reporting period. However, some provincial governments are arguing for a change that would free them from the asset reporting standard.

[12]In 1981, the Canadian Institute of Chartered Accountants (CICA) established the Public Sector Accounting and Auditing Board, now referred to as PSAB. PSAB has the authority to issue recommendations and guidance with respect to matters of accounting in the public sector. Recommendations are developed in accordance with an extensive process of consultation and debate ("due process") with a national network of associates of CICA who represent the preparers, auditors, and users of government financial statements. Under PSAB's Terms of Reference, the board consists of 12 members, 8 of whom represent government entities responsible for financial reporting and auditing.

Proponents of accrual budgeting at TBS and OAG believe that most of the benefits of the shift to an accrual-based budget will come as a result of improved managerial decisions. OAG officials, while instrumental in promoting the shift to accrual appropriations, were unable to provide specific examples of how certain decisions would be made differently if managers were held to account for appropriations measured by accrual as opposed to those measured by cash. They most frequently point to improvements made in asset management to make their case, arguing, for example, that lease/purchase decisions would not be skewed in favor of the lease under accrual budgeting. However, skeptics argue that if the fiscal framework is still set to a cash-based debt to GDP ratio, managers will still be constrained in their lease/buy decision. In fact, they argue that managers have always had the information to make "better" lease/buy decisions. Instead, the decisions that were made were done so under strict borrowing constraints. If fiscal policy is to continue to focus on debt levels, borrowing constraints will still limit the ability of the manager to obtain the cash needed to buy an asset even though the "budget" would only record the annualized depreciation expense.

Implementation Issues

Most of the other countries in our study have approached accrual budgeting and its implementation differently than has Canada. Canada followed a more incremental path in choosing to accrue pensions and accounts payable and is still making decisions about other items, such as capital. Canada has only recently taken the first steps towards the adoption of a full accrual budget by approving the decision to go forward with plans on how best to present their Estimates on an accrual basis for capital. Critical issues, such as reconciliation of the Estimates with fiscal policy, have yet to be worked out.

Two critical implementation issues have been identified—the need for training in accrual concepts and in new management strategies, and the importance of a significant cultural change. Because this effort is in the early stages, these have yet to be resolved. According to officials in OAG and TBS, while most of those who will work in the departments on the new decentralized accounting systems have some experience with accruals, most of those who work on budgeting do not. Training for budget development staff is expected to be extensive over many years. In addition, new skills will be needed in TBS. As the central agency for financial information, TBS will no longer control spending the same way it did in the past. Instead, it plans to offer guidance to the departments and review the

departments' financial statements and budgets from a financial analysis perspective.

OAG also recognized in its recent report that to ensure the success of FIS, central agencies still need to secure departmental "buy-in" and the departments must put in place the necessary systems and training needed to achieve success. We found in New Zealand and Australia that top-level support and commitment to reforms were viewed as key elements to successfully implementing accrual budgeting.

Iceland

Iceland began to consider reforms of its public sector in the early 1990s partly in reaction to internal pressures brought on by years of deficit spending and high inflation rates. Iceland's accession to the European Economic Area in 1994 and the requirements for membership also encouraged an atmosphere conducive to public sector reforms. While the goals of Iceland's reform efforts are broad, as in many of the other countries in our study, Iceland has approached this effort incrementally. Many specific reforms have already been enacted and implemented, such as the Financial Reporting Reforms which address the issue of accrual budgeting; however, at the time of our visit initiatives to adopt performance goals and manage for results were only in their infancy.

Background

Iceland is a parliamentary democracy with a President, Prime Minister and Cabinet, and a judiciary. The Parliament, or Althingi, has 63 members. Each minister in the Cabinet is a member of the Althingi. The President has limited powers, with the Prime Minister and Cabinet ministers exercising most executive functions. Iceland considers itself a "modern welfare state." The Ministry of Health and Social Security comprises nearly 40 percent of the central government budget. It finances hospitals, health care services, and old-age and disability pensions. The Education Ministry is the second largest ministry and is responsible for higher education. Primary and secondary schools are run by local governments. Together these two ministries account for more than half of the government budget. Iceland does not have a military force.

Government Structure

The present government, a coalition of the conservative Independency Party (IP) and the centrist Progressive Party (PP), came into office following parliamentary elections in 1995, succeeding a coalition of the Independency Party and the Social Democratic Party which had been in office since 1991. The IP-PP coalition continues in office following the parliamentary elections in 1999. Iceland's Prime Minister is Mr. David Oddsson who has led both coalitions since 1991.

There are two levels of government in Iceland—local and central. Local governments are elected and have the authority to levy taxes and enter into contracts for public works projects that require central government cost sharing. Primary schools are run and financed locally whereas secondary schools—roughly from age 16 and on—are run and financed by the central government. The central government and local governments share costs for certain investment projects, such as local hospitals, community health

centers, and nursing homes. In most cases the central government paid 85 percent of the costs and the local governments were responsible for the remainder. In the past these cost-sharing obligations led to intergovernmental pressures as local governments went forward with investment projects despite central government budget constraints. According to Ministry of Finance officials, in several cases local governments financed projects and then demanded that the central government reimburse them for its share, frustrating the central government's efforts to set budget priorities. This issue has been ameliorated, however, since certain reforms were enacted in 1996. Now no ministry can obligate central government resources without obtaining authorization from the Ministry of Finance. Likewise, local governments must obtain agreement from the appropriate Ministry before signing a contract that would also require central government financial participation.

Budget Process

The government introduces its budget for the next fiscal year on October 1 and it is normally passed a few weeks before the start of the new fiscal year on January 1. The annual budget is developed using the previous year's budget levels as a baseline, with adjustments for inflation, new salary agreements, extraordinary charges, and new policy initiatives. The process itself is continuous as the development of the next year's budget begins almost as soon as the current year's budget is passed.

A new budget process—"frame budgeting"—was introduced in 1991. Early in the budget development process, ministries are allocated a share of resources for continuation of existing programs based on projected revenues and overall fiscal policy objectives. New spending initiatives are given closer scrutiny by a special cabinet committee and in most cases ministries are expected to find funding for new initiatives through savings from current spending levels.

The Ministry of Finance prepares the budget. During the final stages of the budget development process there are frequent meetings that include the Chairman and Vice Chairman of the Budget Committee, the various ministers, and officials with the Ministry of Finance. A summary version of the budget is put to the majority members of Parliament for approval before it is finalized. The rest of Parliament sees the budget when it is introduced by the Minister of Finance on October 1. Normally the budget is introduced with a speech by the Minister of Finance at the beginning of the first reading. An extensive debate ensues that can last up to 2 days. The full Parliament then passes the budget to the Budget Committee where it will be reviewed in detail for up to 3 months.[1]

During this process the Budget Committee typically delegates oversight and review of a particular ministry's budget to the standing committees that have general oversight responsibilities over those ministries. Standing committees have some authority to direct funding within a ministry's allocation and toward the end of their review they generally hold hearings to communicate to the Ministry of Finance and the Budget Committee what they think should occur in their ministry's budget. A report on the standing committee's recommendations is then transmitted to the Budget Committee for further guidance.

It is generally agreed that while the Althingi must approve the budget and thus must approve all spending, there are few parliamentary controls over spending. In practice, the Althingi makes no major changes in the final budget from what is proposed by the Ministry of Finance. The last time there was a major difference was in 1987 when the total budget package was reduced by about 5 percent. There was also a slight adjustment of about ½ percent in the 1997 budget.

The Economy and the Budget

Iceland's economy historically has been susceptible to inflation and is highly dependent on foreign trade. Inflation rose to 43 percent in 1974 and 59 percent in 1980, falling to 15 percent in 1987 but rising again to 30 percent in 1988. Since then, the inflation rate has dramatically fallen. Although monetary policy is driven largely through exchange rate targets,

[1]There are 12 standing committees in the Althingi but the two with the most prominent role in the budget process are the Budget Committee and the Economics and Trade Committee. The Economics and Trade Committee has jurisdiction over all revenues, while the Budget Committee oversees the expenditure side of the budget. Each committee is chaired by a member of Parliament with ties to the political party(ies) in the government.

officials with the Central Bank said that fiscal policy does influence their strategies. The current government is committed to tight fiscal measures.

In 1995, the new government declared its intentions to reduce the deficit and reach a balanced budget by 1997. The government also recognized the need not only for a balanced budget but also for sufficiently large surpluses in the next few years to cover outstanding Treasury debt and future pension commitments. In addition, it recognized the need to generate surpluses to reduce the outstanding government debt. Although the government's fiscal policy is described as "tight," the Ministry of Finance also notes that the recent surpluses have resulted not necessarily from expenditure constraints alone, but are also the result of the stronger than expected economy and the impact this has had on revenues.

The Icelandic economy has gone through a period of rapid growth since 1994. Growth was particularly strong for the last four years. Inflation has been kept in check. The unemployment rate has been kept at nearly the full employment level as many large investment projects are underway. All of these events have resulted in an unusually large increase in real disposable incomes and in private consumption that contribute to above average revenue collections from income taxes and the value added tax.

Iceland's economic policy has focused, of late, on promoting and maintaining economic stability by shifting away from market intervention and towards liberalization of the markets and increased competition. The overriding economic policy concern of the government has been to maintain and strengthen the stability of the Icelandic economy to ensure continued economic growth and increased employment. A credible fiscal and monetary policy was seen as a prerequisite for this, since this would lead to lower interest rates and encourage private investment. In both fiscal years 1998 and 1999 cash budget surpluses were achieved. The fiscal year 2000 budget is also projected to run a large cash surplus reversing the trend of continuous deficits since the mid-1980s.

Recent Reforms

Accrual budgeting is only a small part of the greater effort undertaken in Iceland over the last 8 years to promote improvements in public sector financial management. Senior officials with the Ministry of Finance indicated that the overarching theme behind all these reforms has been to promote transparency and accountability, specifically to recognize the full costs of commitments when they are made rather than when they need to be paid. In addition to the Financial Reporting Act, several important laws

have been enacted to contribute to the overall goals of reforming the public sector; these include pension reforms, limitations on the extent to which government guarantees are granted, and civil service restructuring.

Notably, in enacting financial reporting reforms, decisionmakers restructured the revenue side of the budget. Previously, earmarked revenues were often subtracted from budgeted expenditures of the beneficiary agencies thus masking the full economic impact of government finances. Now all revenues are presented together in the Operating Statement. These reforms also created a direct link between spending authority and the means of financing. In the past a separate credit budget was enacted that authorized the borrowing necessary to finance the spending approved in the fiscal budget. Now the borrowing requirements are directly linked to the budget through the Statement of Cash Flows. In addition, in order to make direct links between the budget and the financial statements, financial reporting reforms also require that the budget be presented both on an accrual and cash basis. To the extent that the accrual treatment of select budgetary items captures the future financial liabilities of the government, this aspect of the reform serves to enhance the transparency of the financial impact of government decisions.

As will be explained later and in more detail, capital assets are not budgeted or accounted for on an accrual basis. In order to highlight the budgetary impact of capital decisions on future years' budgets, the reforms require longer term financial plans for major capital projects. Even though these plans are not binding, they do provide more information on the likely budgetary impact of capital decisions than was previously presented.

Use of Accruals in Financial Management

In 1994, the government submitted the Financial Reporting Act to the Althingi. The act was based on work conducted over the previous 5 years by the Financial Reporting Commission.[2] The Commission recommended significant changes in the format of the budget and the financial statements; specifically the budget and the financial statements should be reported on an accrual basis, the two should be presented in a uniform format, and their presentation should be based on private sector reporting

[2]The Financial Reporting Commission is a statutory board established by the Financial Reporting Act of 1966 with six ex-officio members representing the Ministry of Finance, the State Accounting Office, the National Audit Office, the Bureau of Statistics, the Central Bank, and the National Economic Institute.

standards as far as practicable. The Commission reasoned that given that the financial statements are the final report on the government's finances for each fiscal year, they are the basic source of information on the government's finances as a whole and for individual agencies. In addition, the audited financial statements should enable the government's finances to be judged by their impact on the economy largely by analyzing changes—measured on a consistent basis and using generally accepted accounting standards—from one reporting period to another. They also noted that the statements are the framework for the Althingi to monitor whether its decisions in the budget have been implemented.

Overview of Use of Accrual for Financial Reporting and Budgeting

In reviewing the applicability of private sector accrual accounting standards for public sector reporting and budgeting the Commission recommended one significant deviation. Namely, property, plant, and equipment (physical capital) are not reported as assets and will continue to be reported as expenditures when purchased. In deciding against adopting private sector reporting standards for capital, the Commission recognized that the private sector standards would make it easier to compare the performance of one agency with that of another and with private sector alternatives. However, there were also problems with implementation; for example, reporting depreciation requires assets to be valued and their useful lives estimated. The Commission found that this was in many cases not practicable for many government assets. It noted, in particular, difficulties in establishing values for large infrastructure projects, museums, national parks, etc. It also questioned the purpose served by depreciating these assets. The Commission concluded that reporting the annual depreciation of assets, instead of the purchase of assets, goes against the objective of showing how all tax revenue is allocated in a given year.

A second deviation from private sector reporting standards deals with the treatment of interest expense. The Commission noted that the private sector standards were currently under review and were likely to change in the next few years to conform to international standards. While a goal of financial reporting reforms was to align the public sector accounting standards with those in the private sector, the fact that changes in private sector standards were imminent led to a decision to defer changes to the public sector standard. The central government records all interest expense, even that portion of the expense that is the result of currency fluctuations on non-krónur denominated loans.

The Commission also recommended a presentation format for budget reporting that sought to align the budget and the financial statements to ensure that decisionmakers, in particular the Althingi, could track the financial results of its budgetary decisions during the previous year. The budget is comprised of two key statements: an Operating Statement that shows accrued revenue and expenses budgeted for a given fiscal year and a Statement of Cash Flows from operations, investments, and financing activities. In addition, supplementary information includes a statement of accounting principles and more detailed statements of loans and guarantees; holdings in noncentral government activities; property, plant, and equipment; and changes in capital. The Statement of Cash Flows is generally in line with private sector practice and represents the net borrowing requirement. This measure is believed to give the best picture of the government's impact on the economy.

Factors Driving Adoption of Accrual Budgeting

The primary intent of the broad financial reporting reforms is to improve the transparency of financial information through uniform reporting standards and through the recognition of the full cost of central government obligations when they are made. Financial reporting reforms have taken shape in response to new information technologies, new requirements of international organizations for uniform data from their member countries, new methodologies to illuminate the impact that government finances have on the economy, and increased oversight by the Althingi in economic and budgetary matters. As previously noted, Ministry of Finance officials consider accrual budgeting to be only one part of a broader effort to reform the public sector in Iceland. Accruing the costs of certain government obligations is considered to be one part of improving the recognition of the full costs of these various obligations.

Summary of Accrual Budgeting System

In two key aspects, Iceland's approach to accrual budgeting differs significantly from the approaches adopted in the other countries in our study. First, in an attempt to satisfy all the key users of financial information, the Operating Statement section of the budget is presented both on an accrual and a cash basis. Second, as noted previously, capital is expensed rather than capitalized and depreciated. Although a significant realignment of the budget occurred as a result of the reforms, this effort was designed to bring more activities into the fiscal budget—creating linkages in the decision-making process—rather than to realign resources to programs and activities as in other countries in our study.

Structure of Appropriations

The main focus of the budget debate is on the Operating Statement, which is presented on both a cash and an accrual basis. The Operating Statement shows revenues by major classes, e.g., individual income tax, corporate income tax, and value-added tax. Revenues are followed by expenses organized by ministry or other major administrative categories such as interest expense. The difference between revenues and expenses—the operating balance—is only presented on an accrual basis. Passage of the budget provides authority to spend.

The Operating Statement is followed by the Statement of Cash Flow, which reconciles any accrued gains/losses and noncash expenses to cash to provide information on the government's Net Borrowing Requirement. Detailed departmental spending by subadministrative unit and program is measured on an accrual basis only and follows the Statement of Cash Flows.

Treatment of Specific Budget Items

- **Revenues** are accrued. The Revenue Department in the Ministry of Finance calculates and estimates all revenues levied based on current laws using projections of income and sales. The total amount of all taxes levied in that year is presented as accrued revenues in the budget. The total revenues in the cash budget represent the sum of all cash projected to be received in the budget year. Uncollectible taxes and forfeited taxes are expensed in the accrual budget under the Ministry of Finance's budget.
- **Operating costs**, such as salaries and supplies, are accrued but in practice the differences between the accrual-based costs and the cash-based operating costs are immaterial.
- **Capital** is expensed as acquired. Major infrastructure projects—for example roads, bridges, and tunnels—are expensed as work is completed and paid for. If a major project extends over multiple fiscal years, only the amount actually paid in that year is recognized in the annual financial statements and only the amount of cash expected to be paid out each year is recognized in the annual budget.
- **Accounts payable** are accrued but the only department with material accounts payable is the Public Roads Administration (PRA). PRA officials admitted that they have substantial flexibility to reprogram funds. For example, when budget estimates differed from actual work completed, PRA could shift funds from projects where pay-outs were less than anticipated or borrow from contractors until the next budget year. Such borrowing in essence would defer payment until new budgetary resources were available. In the 1999 budget, resources were

approved to liquidate the accrued accounts payable liability and fully fund new projects. The practice of deferring payments is discouraged and some officials hope that the longer term focus of the new road building plans will prevent the need for these practices to continue.

- **Non-capital inventory costs** are accrued, but do not differ materially from cash treatment. Since capital is expensed in the year it is purchased the budgetary impact of the accrual of any capital inventory expense will be the same as if treated as a cash expense.
- **Public sector pensions** are accrued. Pensions are centralized and these liabilities and their related expenses are shown in the Ministry of Finance's budget—not in the budgets of the various ministries. One of the major goals of the reform efforts in Iceland was to improve the way that public sector pensions were recognized in the financial statements and the budget. The initial accrual of unfunded pension liabilities in the 1989 financial statements and the resulting realization by the government and the Althingi of their large size was one of the issues that precipitated the complete review of Iceland's financial reporting practices, according to Ministry of Finance officials. The realization also prompted changes to the public sector pension scheme. The previous scheme has been closed to all new employees since 1997 and in its place a new fully funded pension scheme was adopted. Those in the previous system were offered a choice of shifting to the new system with some benefits transferred. The accumulated liabilities of the old scheme are recognized in the financial statements but only the annual changes in those liabilities are shown in the current budget. All future liabilities in the new scheme are expensed on an accrual basis.
- Iceland recognizes and has made some effort to prepare for significant demographic changes as a result of the aging of the population. For example, Iceland recently enacted pension reforms aimed at increasing national saving and strengthening pension plans for private workers.[3] While Iceland mandates universal pension coverage for private sector employees, there are also two levels to Iceland's social insurance for the aged—a small old-age pension program for people who have never entered the workforce and general welfare programs. The total expenditure budgeted for the former in 1999 was only Kr. 225 million (.1 percent of total expenditures)—Kr. 200 million in cash and Kr. 25 million

[3]Private sector pension reforms were recently enacted that aim to increase national saving by providing favorable tax treatment on a larger share of personal income if it is invested in long-term pension schemes. Reforms also require the consolidation of private sector pension plans to ensure greater diversification of investment risk as any liability accruing to them would not be a government liability.

accrued for future payments. Ministry of Finance officials said that this small program was being terminated and those that would have been eligible in the future will be taken care of through the general welfare programs. In contrast, the general welfare programs are very large and are not accrued. In 1999, the total general welfare budget for the aged and disabled was funded through the Ministry of Health and Social Security at Kr. 17.7 billion (about 9 percent of total expenditures). The largest share of this program, about Kr. 14.96 billion (84 percent of program expenditures and 8 percent of government expenditures) provides funds for old-age and disabled benefits. Basic old-age benefits are paid to all persons 67 years old and older and are means-tested. A Ministry of Finance official said that since there is no guarantee on the level of the benefits, there is no reason to accrue a liability for the costs of these benefits.

- Iceland makes loans to state-owned enterprises and funds, continues to offer below market rate student loans, and has a housing loan fund. New loans are booked at their net present value, incorporating any subsidy costs and default risks. The value of existing loans is reestimated by the National Audit Office. Subsidy costs are included in the Ministry of Finance's budget. Operating costs of the loan programs are included in the individual agency's budget. The operating balance is adjusted by cash flows for investing to get to the cash-based net borrowing requirements. The State Guarantee Act considerably narrowed the authority of the government to issue state guarantees, but it calls for an assessment of risk before a guarantee is issued and the establishment of a loan loss account to provide for losses on state guarantees. A risk premium is called for on all issues of state guarantees.
- Ministry of Finance officials said that Iceland offers a natural disaster insurance program that provides funds to those who suffer from the effects of earthquakes, volcanic eruptions, and floods that occur regularly in Iceland as a result of its situation on a geographical fault line. The budget treatment for this insurance is cash-based. Premiums are not based on a formal risk assessment but the balance in the fund is normally enough to cover the needs that arise in a year. The costs associated with such disasters are normally paid for either through the premium balances or through a special appropriation.

Description of Aggregate Budget Measure

The main focus of the budget debate is on the Operating Statement, which shows estimates of revenue and expenses on both an accrual and a cash basis. However, as recommended by the Financial Reporting Commission, the Operating Statement section of the budget shows the operating result

(deficit/surplus) only on an accrual basis even though the detailed presentation of both cash and accrual estimates is maintained in the rest of the Operating Statement. Although the cash-based deficit/surplus figure is not presented in the Operating Statement, the cash flow statement reconciles the accrual budget to the government's borrowing requirement, which the Commission believes is the best picture of the government's impact on the economy.

Key Differences Between Cash and Accruals

The only areas of the budget where there are significant differences in the cash and accrual treatment are in revenues, pensions, and interest. The oversight and administration of these activities are localized in the Ministry of Finance.

Cash Flows Versus Accrual Operating Balance

The accrual-based operating balance is adjusted for cash flows from operating and investing activities to get to the net borrowing requirements or, as in the case of Iceland since 1998, the net debt repayment potential. It is then further adjusted for changes resulting from financing activities, which detail the government's plans to repay or restructure its debt. Key budget documents show a clear link between the net movement in cash balances and the debt reduction goals for the fiscal year. Since fiscal year 1998, as a result of the cash flows from operating and investing activities, the government reduced its gross debt to GDP ratio to 34 percent from a high of 51½ percent in 1995. The fiscal year 2000 budget also projects continued cash surpluses and further debt reduction to about 30 percent of GDP.

Views on Implications for Decision-making

Iceland's current fiscal policy has been described as tight with a goal of debt reduction. Iceland's selective approach to accrual budgeting has lent itself well to this policy. Accrual treatment of capital in a budget usually means that the purchase price of the capital is not recorded when the actual cash outlays are made but instead is spread over the asset's useful life. On the other hand, accrual treatment of many other budget items, such as pensions, insurance, and credit programs often result in recording a greater amount of budgetary resources up front in comparison to cash budgeting. In choosing to accrue only those items that would require more up front funding on an accrual basis and against accruing those items that would require less, Iceland effectively reserves more cash resources that can be used to repay debt than if the budget was only measured on cash or full accrual. Specifically, the budgeted surplus measured on a cash basis for 1999 was higher than the budgeted surplus measured on an accrual basis.[4] By focusing on the accrual-based surplus (which in effect reserved some cash for future payments), Iceland was able to use the "extra" cash to pay down more debt.

The impact on the rest of the budget of the use of accrual measurement for only select budgetary items has been to constrain spending in other areas in order to meet or exceed fiscal targets. The budget shows the deficit/surplus only on an accrual basis. At the time of our visit Ministry of Finance officials expressed concern that if they showed a large cash surplus there would be increased pressures to spend, reducing the amount available to buy back debt. The cash-based surplus number could be easily arrived at by summing the cash column, but Ministry of Finance officials acknowledged that they hoped to focus the debate on the accrual measure of fiscal position.

Unlike in many of the other countries in our study, the approach taken for accrual budgeting in Iceland is not anticipated to affect managerial decision-making at the ministry level. In most of the other countries, the capitalization of assets will result in the most significant changes to individual department or agency budgets. In Iceland, however, assets are not capitalized and pension expense—the only other budget item that is significantly different under accrual budgeting—has been consolidated in a

[4] In fiscal year 2000 the cash-based surplus is projected to be 33 percent higher than the accrual-based surplus.

central agency and will not influence managerial decision-making at the agency level.

Senior officials with the Ministry of Health and Social Security disagreed with the Financial Reporting Commission's decision against the capitalization of assets. The Ministry of Health and Social Security is the largest in terms of budgetary resources and is capital-intensive with state-owned hospitals and very expensive medical equipment. As new medical technologies are developed, the ministry must perform cost analyses to determine whether it should make the investment to develop expertise in a new technique—or purchase new equipment—or whether it is more cost effective to send its citizens abroad for treatment.[5] This information has been collected on an accrual basis and analyzed for many years in the ministry because it needs the information and analysis to perform its functions. In essence it must maintain two sets of books because the accrual information is not requested by the Ministry of Finance, the Cabinet, or the Althingi. From a managerial perspective, therefore, the ministry sees great value in capitalizing assets.

In a broad managerial sense, however, the package of public sector employee pension benefits may be scrutinized more heavily by various decisionmakers and the public than in the past as a result of the adoption of accrual treatment of those benefits in the budget. In 1998 the Ministry of Finance negotiated a new wage agreement with public sector employees.[6] Pensioners receive a pension tied to the base salary of the person who is currently in the job; therefore, wage renegotiations have a direct impact on the pension liability. According to the editor of one of the leading newspapers, there is the perception that public sector employees receive better salaries, pensions, and other benefits than workers in the private sector receive. When the new wage agreement was announced concern was raised regarding its costs, but it was not until the June reestimates of the budget—on an accrual basis—were announced in August that the full costs were known. There was a great deal of public outcry in the press and

[5]In Iceland health care is provided to all citizens. In addition, citizens of other countries are offered health care if they are visiting or working in Iceland. If a health care provider in Iceland treats a citizen of another country, Iceland must provide cost information, prepared under generally accepted standards, in order to collect payment from the health plan in the other country.

[6]The Ministry of Finance is responsible for negotiating the wage agreements with public sector employees; no parliamentary agreement is required.

among parliamentarians regarding the cost of this agreement; specifically, there were concerns that the full cost should have been known before the agreement was reached. Ministry of Finance officials said that it was very difficult to estimate these costs as the agreement was being negotiated, but added that in the future the full costs of new policy decisions will likely be more fully debated before any agreements are reached. There is no longer support to give something in the short term that is costly in the long term.

Efforts are underway to implement performance management strategies, such as developing ministerial goals and objectives, increasing accountability for results through performance contracts, and outsourcing some government functions. These efforts are only in their very early stages of implementation and ministry officials have not tied budgetary resources to results.

Implementation Issues

Unlike many of the other countries in our study, Iceland mitigated the costs and time required to train ministry staff in accrual concepts by consolidating the development, analysis, and presentation of the methodologically complex accrual estimates within the Ministry of Finance. Officials from the Ministry of Finance said that ministry and State Accounting Office staff were trained accountants and did not have difficulty adjusting to the new measurement techniques.

The Netherlands

In the 1980s, the Netherlands found itself in circumstances similar to those of many other industrialized countries with burgeoning deficits, high unemployment, and declining public confidence in the public sector's ability to deliver promised services and programs. In response the government sought not only to reduce the deficit but also ways to reduce the public sector's role in the economy—largely through privatization, deregulation, and decentralization. Since 1992, the Netherlands increasingly has adopted performance management initiatives to achieve these objectives and to improve the efficiency of the public sector. The government viewed accrual budgeting and financial statement reporting as providing the framework necessary to manage for results. An accrual framework is being applied only in those specific agencies where it was deemed useful in promoting results-oriented management. When the first agencies began employing accrual measurement in 1994 it was seen as a pilot effort, but there is no plan for these agencies to revert back to a cash basis of accounting and budgeting. Cash-based budgeting continues at the aggregate level to record total expenditures and receipts and remains the focus for fiscal policy decision-making.

Background

The Netherlands is a parliamentary democracy under a constitutional monarch. Its government is based on the principles of ministerial responsibility and parliamentary governance. The national government comprises three main institutions: the Monarch, the Council of Ministers, and the Parliament. The Council of Ministers plans and implements government policy. Most ministers also head government ministries. The ministers are responsible to the Parliament, but unlike the British westministerial system, Dutch ministers cannot simultaneously be members of Parliament. There are 12 provinces, each governed by a locally elected provincial council and a provincial executive appointed by members of the provincial council.

Government Structure

The Dutch Parliament consists of two houses—the First and Second Chambers. The First Chamber has 75 members elected by the 12 provincial councils. As a general rule they meet for only about 1 day per week and usually consider broad policy issues, focusing little attention on budget issues. The Second Chamber consists of 150 members elected for 4-year terms on the basis of a nationwide system of proportional representation. Members represent the whole country rather than individual districts and are normally elected on a party slate, not individually.

Only the Second Chamber may initiate legislation and amend bills submitted by the Council of Ministers. All legislation passed by the Second Chamber must be approved by the First Chamber before it can become law. Both Chambers may question ministers and other government officials about proposed or existing programs.

The Monarch appoints the formateur who forms the Council of Ministers after the elections. Historically, Dutch governments have been based on the support of a majority in both houses of parliament. The current government is a three-way coalition formed in August 1998 and led by Prime Minister Wim Kok of the Labor Party. The three-way coalition government holds 97 of the 150 seats in the Second Chamber. Prime Minister Kok also led the coalition that governed from 1994 to August 1998.

Economy and the Budget

The Dutch economy, like most other Organization of Economic Cooperation and Development (OECD) economies, experienced sluggish growth and rising unemployment in the late 1970s and early 1980s. In 1982, the Netherlands found itself in its most severe post-war recession with negative growth in its gross domestic product (GDP), measured at -1.2 percent in both 1981 and 1982. A new government was formed in late 1982 and faced what many considered an unsustainable situation. Government debt had doubled since the early 1970s and total government outlays exceeded 60 percent of GDP. The deficit (9.5 percent of GDP in 1983) was putting an upward pressure on interest rates, hindering growth in the private sector. Although the budget deficits were exacerbated by a slumping economy, much of the budget stress was structural, reflecting the predominance of transfer payments in the budget. The government estimated that only half of the increase in the deficit could be attributed to the business cycle. There were widespread concerns about the implications of the structural deficit for financial markets and business investment.

Reducing the deficit was the principal objective of the governing coalition that formed in 1982. Actual government spending fell 2.5 percent by 1986 and, while the deficit also fell, it was still about .75 percentage points above the goal set by the government. A new coalition government formed in 1986 called for renewed fiscal restraint and set goals for further deficit reduction. Most of the real cuts in spending were in public investment; its share of GDP had been declining steadily since the 1970s but reached historic lows in the late 1980s. Real cuts in public sector wages and transfer

payments were achieved, however the number of recipients did not decline. Instead, wages and benefits did not grow as rapidly as inflation.

The economy improved in the late 1980s and reforms to the country's disability benefit system and lower subsidies for housing, public transportation, and education ameliorated some of the budget's structural imbalance. Given the size of the public sector, greater productivity was viewed as an important step in meeting new spending pressures under tight fiscal constraints. In the early 1990s, the government sought further improvements in management of the public sector through the introduction of market discipline and market processes. The government hoped that small improvements in productivity combined with modest wage increases would lead to savings of about a quarter percent in public sector wage bills.

Government finances have improved substantially since 1994. The coalition government in power from 1994-1998 took actions that resulted in a reduction in the deficit from 3.8 percent of GDP in 1994 to about 1 percent of GDP in 1999. Similarly, since 1994 the debt-to-GDP ratio has been reduced from about 78 percent to 64 percent. The Netherlands is firmly committed to the European Economic and Monetary Union and was able to comply with the convergence criteria established in the Maastricht Treaty.[1]

[1]An important condition for successfully moving to a single European currency on January 1, 1999, was that the economies of the participating countries should converge towards each other and, at the same time, remain healthy.

The economy peaked in 1998 with strong 4 percent growth in GDP, sharply falling unemployment, and moderate inflation. GDP growth for 1999 and 2000 is expected to slow to about 2.75 and 2.5 percent, respectively, but unemployment is expected to remain low at about 5 percent of the labor force. The fiscal and budgetary policies of the current coalition government seek to maintain the momentum achieved by previous governments in shrinking the deficit, reducing the debt-to-GDP ratio, and rebalancing the public sector's role in the economy largely through deregulation. In addition, this government has stated its commitment to enhancing the infrastructure base. When the government put together its fiscal year 1999[2] budget it estimated economic growth at about 2.25 percent. Based on trends for the first half of the year, the growth rate is expected to reach 2.75 percent. As a result of the better-than-expected economic performance in 1999, the government's fiscal year 2000 budget plans to reduce the deficit to about one-half percent of GDP while providing for tax cuts[3] and investment in environmentally conscious improvements in public sector infrastructure.

Budget Reforms

Faced with daunting deficits in the early 1980s, the government developed plans to improve financial accountability and the efficiency and effectiveness of the public sector. Government officials also began to explore ways to shrink the public sector's role in the economy. Many different approaches were taken to streamline government; privatization, deregulation, and decentralization were chief among them. A 1998 study reported that the fact that few entities were actually privatized was attributed, in part, to the fact that the cash-based accounting systems then in use did not provide enough insight into costs to permit fair prices to be estimated by either potential buyers or the government.[4]

[2]The fiscal year corresponds to the calendar year.

[3]The governing coalition agreed to set aside half of any revenue "windfalls" for tax reduction and the other half for deficit reduction.

[4]Haffner, Robert C. G. and Koen G. Berden, "Reforming Public Enterprises – Case Studies: The Netherlands," Public Management Service, OECD, 1998.

The Netherlands made significant progress improving the quality and timeliness of its financial accounting system during the late 1980s. However, instead of again attempting privatization of some public entities, in 1992 the government sought to improve the effectiveness of public sector activities by focusing on a more results-oriented performance management model. Taking an incremental approach to change, the government and Parliament decided to allow a few government entities to operate as if they were in the private sector. Parliament further insisted that before an entity could shift to this new framework it needed to define clearly the products it intended to provide and describe how it intended to achieve any promised efficiencies. Accrual accounting and budgeting was thought to be useful in achieving such efficiencies. The Ministry of Finance noted that some activities could be better supported through the use of accrual measures to spur a more results-based management focus. Specifically, a government report found that accrual measurement would facilitate a better costing of some government activity.[5] The Ministry of Finance reasoned that efficiency gains could be achieved through this more results-oriented environment if expected outputs were more clearly articulated and the associated costs of producing those outputs were better aligned.

Adoption of an accrual framework, even for a limited number of public entities, required an amendment to the Government Accounts Act which required cash treatment for both budgeting and financial reporting on budget execution. The selected entities were deemed "agencies"—a new subdivision of government. According to parliamentary staff, once the Government Accounts Act was amended, entities could volunteer to become agencies. The first four new agencies were created in 1994. Over the years, many more entities have elected to participate. Currently there are 22 agencies and 10 more entities are considering becoming agencies. The share of public sector expenditures currently made by agencies is small—only about 5 percent. However, they are labor intensive, employing about 25 percent of all public sector employees. The Dutch Tax Department recently applied for agency status and, if its application were approved, the share of public sector employees in agencies would rise to 50 percent. However, because most of the Netherlands' budget is transfer

[5]Public sector accounting standards largely mirror those used in the Dutch private sector. Municipal governments in the Netherlands use accrual-based standards for financial statement reporting and budgeting. Discussions are ongoing in the Ministry of Finance on whether these standards need to be reviewed for applicability to the public sector.

payments, the share of total public expenditures budgeted on an accrual basis will remain small. The rest of government still budgets on a cash basis and, when all department and agency budgets are consolidated, the fiscal balance is reported on a cash basis.

Capital investment suffered in the 1980s even as the Netherlands tried to rein in spending on social programs. Parliament's Public Expenditure Committee promoted the adoption of a separate capital budget, which successive governments also supported. However, there were also many who opposed this separation, arguing that a capital budget would highlight the lack of capital investment and that, by accruing only the depreciation costs, a capital budget would provide greater incentives to spend the scarce cash available in the Treasury. In the end, the overriding fiscal policy goal at the time was to bring the deficit to within the European Union's (EU) requirements. The EU deficit targets are cash-based and the government at the time felt that a shift to a full accrual-based capital budget could be deferred.

Structure of Agencies' Accrual Appropriations

The government's budget is developed and presented to the Parliament by government ministries. Agencies are sub-units of ministries; their budgets are approved and appropriated through the various ministries as prices paid by the ministries for outputs. At the ministerial level, appropriations are cash-based even though the amounts appropriated are based on the agencies' accrual-based costs. For example, the Prison Service is a line item in the budget of the Ministry of Justice.[6] In this output budgeting framework, the Ministry of Justice buys the services, for example, the number of prison beds it needs that year (a proxy for the number of prisoners), from Prison Services. The Ministry of Justice is appropriated funds on a cash basis to buy services from the Prison Service, which are priced on an accrual basis.

While the goal of this framework is to encourage agencies to benchmark their prices against other providers—public or private—of similar services, this has been done infrequently. Instead, the price usually reflects the costs of production. Thus, in the above example, the price the Ministry of Justice agrees to pay the Prison Service is based on the accrual-based costs the

[6]In most cases an agency is one line item within its Ministry's budget. However, there are some very small agencies that may be included with other program expenses within a line item in their ministries' budgets.

agency will incur in providing the service. This price will include many noncash expenses, such as depreciation, which are part of the costs. The lack of widespread benchmarking to determine prices was attributed to inexperience with accrual measures, the recent accession of many new agencies in the program, and the fact that for some of the services these agencies provide there is no private sector equivalent that can be used for benchmarking. Ultimately, as more agencies become accustomed to accrual measurement, there is an expectation that they should be able to benchmark their prices. In theory, this will lead to the identification of efficiencies as agencies seek to compete with providers of similar services.

Agencies must produce a set of accrual-based financial statements at year-end. These statements are audited by the Netherlands Court of Audit and presented by mid-May for the fiscal year that ended the previous December. Budget development begins in the ministries about this same time and, as input to budget development, the agencies' previous year's statements are reviewed by the cognizant ministry, the Ministry of Finance, and ultimately the Parliament. An agency's operating result is scrutinized to ensure that the appropriated price was sufficient to cover all costs and that the agency is not operating at a loss.

A change was recently made to the way agencies finance future capital investments. Prior to the change, agencies accumulated depreciation funding until they could finance a capital investment. Agencies can now borrow money for such investments from the Treasury. Agencies will use their accumulated depreciation and other savings[7] to repay the loan.

[7]Also effective in fiscal year 2000, a 5 percent cap was placed on the amount an agency can carry forward from one year to the next, exclusive of depreciation. Reserves greater than 5 percent of its total appropriation signal the need for the agency to lower its price (essentially its budget request).

Since the agencies are still part of the public sector, significant controls are placed on their ability to freely manage all their assets including "savings" and capital assets. For example, any proposed capital acquisition is reviewed by an agency's ministry to evaluate its relevance and need. Capital acquisition plans are presented through the agency's budgeted cash flow statement. Any new loans are noted and plans for such financing are presented by the agency for approval to its ministry and then to the Council of Ministers. All capital acquisition requests must fit within the government's financing constraints and thus the Ministry of Finance must also evaluate the effect the individual plans will have on the deficit before they can be approved.[8] Parliament reviews both the most recent audited financial statements and the budgeted financial statements that are used to develop the price paid to the agencies for their services. However, no specific vote is taken on an agency's capital acquisition plan.

Starting this fiscal year—January 1, 2000—new agencies will have to pay for all assets on their balance sheets when they become agencies. In essence they are purchasing their assets from their ministries. These new agencies will be able to borrow from the Treasury to finance the initial asset purchase. The interest paid on the loans will approximate the cost of capital, i.e., the opportunity cost of holding the assets. The agency's price—and thus its appropriation—will include this cost of capital. Highlighting the cost of holding these assets provides incentives for the agency to better manage its capital base.

As in other countries, significant differences exist in the Netherlands between the cash needed for pension payments to retirees and the accrued costs of current employee pension liabilities. The Dutch public sector employee pension plan is separate from the rest of the government budget. For agency employees, the employer's share of pension costs is transferred directly to this fund and invested. So, while accrued pension costs are included in the agencies' appropriations, they are immediately transferred out of the agencies' control to the general pension fund.

Agencies are permitted to sell their services to entities other than the central government and earn additional revenues, but this has not yet occurred. For example, if the Prison Service finds itself with excess

[8]The deficit/surplus is still largely a cash-based number. Loans for new capital injections are considered outlays and are netted against payments made on existing loans to determine the net effect on the deficit/surplus.

capacity it could take in prisoners from other countries and supplement its Dutch appropriation. However, the cognizant Ministry, the Council of Ministers, and the Parliament all have considerable influence over these transactions due to their oversight of the agency's financial statements. Essentially, they must agree on the agency's income statement and approve of its plans to take in more income. There are also rules that apply to ensure that these public sector agencies do not unfairly compete against the private sector, as agencies are not subject to taxation on this income as the private sector would be. Currently, the greatest concern is that any decision to offer services outside the Netherlands be weighed against the agency's capacity to serve the Dutch people. For example, overcrowded prison conditions could result if the Prison Service management was driven by price competition alone.

Views on Implications for Decision-making

Although accrual budgeting is used for internal cost allocation, it has little impact on fiscal policy since the surplus/deficit is essentially a cash-based number. Accrual budgeting coupled with management reforms was primarily undertaken to achieve management efficiencies. The government believes that clearly specifying the outputs agencies are expected to produce and aligning resources to the outputs provides greater transparency in agency operations. Senior budget officials point to the Prison Service for examples of how such benefits could manifest themselves. When providing services—i.e., the number of prison beds per year—the outputs are spread throughout various facilities. According to these officials, the costs of housing, feeding, and guarding a prisoner should be similar for all facilities. But under the traditional cash-based framework, the costs differ primarily because of capital acquisitions or renovations. Accrual budgeting as implemented in the Netherlands seeks to even out those spikes. Once those costs are evenly allocated, if differences continue to exist, price benchmarking between prisons and other cost analyses can be performed that should encourage price competition. According to officials, this could lead to lower government expenditures. The selective approach to accrual budgeting taken in the Netherlands permits the benefits of accrual accounting to be realized for cost accounting purposes and for agency decision-making, while preserving the cash figure for comparative purposes within the European Monetary Union.

New Zealand

New Zealand adopted accrual budgeting as part of a systematic program of sweeping reforms in both the private and the public sectors that started in 1984. In the public sector, the government aimed (1) to reduce its role in the economy through corporatizing and privatizing government entities and (2) to extract efficiencies and increased accountability from the remaining public sector. Accrual-based reporting was adopted as a tool in these wider management reform efforts. It was seen as providing a coherent framework for systematically determining the output of government, then evaluating performance and accountability in the new decentralized management system. Budgeting was transitioned to a full accrual basis to provide a direct link between the budget, the financial statements, and the results of government activities.

Background

New Zealand has a unicameral parliamentary system with 120 members elected for 3-year terms, with the most recent election occurring in November 1999. It has a mixed-member-proportional electoral system, in which half of Parliament is elected directly as district representatives, while the other half is appointed by each party from its own candidates in proportion to the percentage of the popular vote it receives. The government is headed by the Prime Minister who, along with other Cabinet members, can often make administrative or regulatory changes without public input or legislative approval. Prior to the change to proportional representation, the New Zealand government traditionally was controlled by either one of the two major parties—the Labour Party or the National Party. In 1996, as a result of the introduction of proportional representation that enabled minor parties to have greater representation in Parliament, the National Party entered into an agreement with the New Zealand First Party to form a coalition government. In 1999, another coalition government was formed comprising the Labour and Alliance parties.

The Budget Process

The governing party or Coalition party in power has control over the entire budget process. The government, through the Department of the Treasury, prepares the budget for presentation to Parliament. Before the budget is released, the government releases the Budget Policy Statement (BPS) setting forth the strategic objectives for the upcoming fiscal year (which runs from July 1 to June 30) and the following 3 years. These objectives help define the framework within which new initiatives and programs proposed by departments are to be evaluated. New programs constitute a small part of the overall budget, as most of the budget goes to fund core services. New programs are proposed, considered, and approved prior to

the public presentation of the Budget Economic and Fiscal Update (the budget). The budget sets forth the government's overall plan for revenues and expenditures that fulfills the strategic objectives announced in the Budget Policy Statement. The Minister of Finance also presents the Estimates of Appropriations, which provide detailed information by department and agency, to accompany the budget.

Concurrent with the presentation of the budget, the government is required to release the Fiscal Strategy Report (FSR) to report on whether the actual budget decisions contained in the budget are consistent with the government's short-term fiscal intentions set out in the most recent BPS. Where those intentions have changed, the government is required to state the reasons for the departure. The FSR is to contain projections of fiscal trends over a ten-year period, as well as an assessment of the consistency of these outlooks with the objectives for medium- to long-term fiscal policy stated in the most recent BPS. Again, any inconsistency with the BPS has to be explained.

While the New Zealand Parliament has power to control government finances and appropriate expenses, in reality the budget is usually passed without much change. The failure to pass a budget would signal a lack of confidence and would likely result in the dissolution of the government and new elections. Standing committees in Parliament examine the budget, question ministers and departments about their requests, and report back to Parliament. Parliament may offer modifications to the government's budget through procedures called "Standing Orders." However, these orders also give the government a financial veto if Parliament's changes would result in a significant impact on the "fiscal aggregates," or overall financial position. During the parliamentary deliberation process, the government continues to operate through supply bills.[1]

The Economy and the Budget

From the mid-1980s to the early 1990s, the New Zealand economy experienced a prolonged period of very slow growth. In 1991, real gross domestic product (GDP) was less than 3 percent higher than in 1984, compared to an average increase of more than 20 percent for other Organization of Economic Cooperation and Development countries during the same period. Unemployment soared from less than 5 percent in the

[1]Supply bills allow government agencies to continue operations until permanent appropriations have been made by Parliament.

early 1980s to almost 11 percent in 1991. The economy rebounded starting in late 1991, led by strong export growth. Economic expansion continued until 1996, when the economy started to slow. More recently, the Asian economic crisis has negatively affected New Zealand's growth.

Budget deficits had characterized New Zealand's fiscal position for almost two decades. However, deficit reduction efforts and a strengthening economy have led to the achievement of surpluses from fiscal year 1993-94 through fiscal year 1998-99. These surpluses are measured on an accrual basis—as required by new legislation—as opposed to the cash basis used to measure fiscal position before fiscal year 1993-94. The surpluses, along with proceeds from privatization, have allowed the government to undertake substantial debt reduction. By 1998, net debt had declined to less than 25 percent of GDP from a level of more than 50 percent in 1992. Current projections estimate that the budget will be roughly in balance in fiscal year 1999-2000 before achieving surpluses again starting in fiscal year 2000-01.

Recent Reforms

Between the mid-1980s and mid-1990s, New Zealand implemented systematic and sweeping reforms in the private and public sector that transformed the country from one of the world's most controlled economies outside the communist world to one marked by openness. Reforms affected every sector and reflected several elected governments' views that economic openness and competition were the engines of economic growth. Financial reporting and budget process reforms were the least controversial of all of New Zealand's efforts during this period.

Prior to 1984, the New Zealand government played a substantial role in providing goods and services. In addition to providing extensive subsidies to various businesses, the government owned coal mines, banks, airlines, telecommunications, and other industries that together produced more than 12 percent of GDP. Government policies also focused on maintaining the standard of living of New Zealanders through generous provisions for social programs financed by borrowing heavily from abroad.

The 1984 election brought a new government to power, along with an agenda that focused on introducing competition to a heavily regulated economy and dismantling the state's involvement in the economic sector. To effect this, the government devalued and then floated the currency, opened financial markets to international capital flows and investment, and

deregulated major sectors of the economy. It also removed wage and price controls and reduced or eliminated subsidies from many industries.

After introducing competition in the private sector, the government turned to reforming the public sector. The government's goals were to reduce its size and to adopt modern management practices. The first major step taken to improving performance of the public sector was the State-Owned Enterprises Act of 1986, which organized departments with commercial activities into separate commercial entities and required them to adopt business practices, implement new accounting systems, and compete with private sector entities where applicable. Subsequently, the State Sector Act of 1988 sought to improve accountability and performance in the core public service by reforming it and replacing the permanent tenure system for heads of government departments with a contract system. The act specified that executives would be evaluated on the basis of their performance, and transferred the power to hire, fire, and determine pay levels to each chief executive. Thus, each chief executive is now the employer for his/her department.

The Public Finance Act of 1989 furthered the move towards a new financial management system and enhanced the link between budget and performance at the departmental level by shifting to output-based appropriations for the delivery of services over which departments had control. [2] As a result, at the department level, the measurement basis for budgeting, reporting, and performance assessment was shifted from a cash to an accrual basis.

In 1994, the Fiscal Responsibility Act (FRA) expanded the accrual-based framework to cover all government accounts so that programs such as transfers and loans (which were still being budgeted on a cash basis although they had been reported in financial statements on an accrual basis since 1992) were to be budgeted on an accrual basis. By establishing a set of guiding principles for fiscal decision-making and requiring extensive reporting of fiscal performance, FRA added a new dimension to reforms that were until then primarily oriented towards increasing accountability of departmental executives so as to extract better departmental management. FRA extended this accountability framework to the rest of the government by requiring that the government first articulate its fiscal strategy before

[2] The New Zealand framework differentiates between items controlled by departments and items administered by departments on behalf of the government. (See figure 11.)

budget submission, and then report subsequently on its performance. Whereas in the past, performance and accountability applied to the micromanagement level, they now became characteristics of the fiscal framework as well.

Use of Accruals in Financial Management

Unlike most other countries that have chosen to take an incremental approach to implementing accrual-based reporting, New Zealand viewed accrual accounting and budgeting as a part of a coherent framework. According to New Zealand officials, the adoption of accrual budgeting was the least controversial element of the reform program. There was already a body of knowledge about the shortcomings of the cash system, as well as proven benefits from accruals provided by the experience of state-owned enterprises. Once a new direction was chosen, the government moved quickly towards implementation.

Implementation Timeline

The transition from cash to a full accrual-based system of reporting and budgeting began in 1989.[3] Departments transitioned all key elements, including both accrual budgeting and accrual reporting, at the same time. Before moving onto the new system, departments individually had to receive approval from the Treasury, with the approval hinging on whether departments fulfilled specific requirements. Specifically, each department had to (1) define its broad classes of outputs (the basis for accrual-based appropriations), (2) develop an accrual-based system capable of monthly and annual reporting, (3) develop a cost allocation system to allocate all input costs, including depreciation and overhead, to outputs, and (4) develop a system of cash management. At the end of 2 years, and before the start of the fiscal year 1991-92 budget process, all departments had completed the transition process. In the 1991-92 budget, departments were required to present accrual budgets for their core services using almost 800 output classes instead of the 50-plus departmental appropriations that existed prior to the transition to accrual budgeting. By the end of 1991, all but six departments had received unqualified audit reports. Once individual departments had transitioned into the new financial management system, the government as a whole focused on the aggregated financial reporting of the government. In October 1992, the government presented to Parliament

[3]Starting with the fiscal year 1989-90 budget, New Zealand's fiscal year runs from July 1 to June 30.

the first comprehensive set of accrual-based annual financial statements for the fiscal year ending June 30, 1992. In 1994, following an amendment to the Public Finance Act, the government prepared and presented the entire budget, including loans and transfers, on an accrual basis, thereby completing the transition to the accrual-based framework.

The Public Finance Act distinguishes between three types of appropriations, known as Modes A, B, and C (see figure 9). The three modes range along a continuum, from appropriating for input costs to appropriating for output prices. The three modes recognize that departments are in different stages of adopting reforms and that some departments provide goods and services that are more commercial and subject to competition than others. By 1991, all departments had transitioned out of Mode A into Mode B, which is still the usual mode of appropriation. Departments have not yet transitioned to Mode C, although a number of features that were originally envisaged for Mode C (such as a cost of capital), now apply to Mode B.

Figure 9: The Three Modes of Appropriations

Under **Mode A,** departments are appropriated cash for the purchase of inputs, with separate appropriations for capital expenditures.

Under **Mode B,** appropriations are based on all accrual costs, including noncash costs such as depreciation expense and capital charge, incurred in production of outputs. In practice, departments do not submit new estimates of costs every year. Instead, the full costs of producing outputs, derived from a cost exercise conducted in 1991, form the basis for current appropriation. Cost reviews are performed periodically, often at the request of departments.

Mode C is intended for goods and services that could be subject to competition. Under this mode, departments would be appropriated cash for the fair market price of outputs. They would pay interest, taxes, and dividends in order to be truly competitive with others (including private sector entities) that provide similar goods and services.

The Public Finance Act requires that the financial statements for the New Zealand government and for each government department be prepared in accordance with generally accepted accounting practices. Generally accepted accounting practices are financial reporting standards approved by New Zealand's Accounting Standards Review Board from submissions by the Institute of Chartered Accountants of New Zealand or any other person or body. Rather than developing its own separate standards, the

government adopted generally accepted accounting practices used by entities in the private sector for reporting. If necessary, Treasury officials would develop specific accounting policies within the public accounting framework through the New Zealand standards-setting process. Using the generally accepted accounting practices framework, Treasury officials developed accounting policies that (1) define the reporting entity, (2) specify a system for consolidating information, and (3) develop a format for presenting and publishing the government accounts. The Comptroller and Auditor General's Office, the Finance and Expenditure Select Committee, and experts in the public and private sectors reviewed these policies as they were developed.

Factors Driving Adoption of Accrual Budgeting

New Zealand's approach to accrual budgeting is one of the most comprehensive of the countries that have implemented it to date. In part, it reflected the rejection of a cash system that was not providing proper information for the management of assets and liabilities. The fiscal system in New Zealand's central government had traditionally focused on the annual cash cost of inputs such as personnel, travel, maintenance, and materials. As in most other countries, the government and Parliament exerted control over inputs by mandating the use of specific suppliers and regulated compliance through extensive instructions. Budgeting took the form of a set of appropriations of cash payments to recipients, to a government activity, or to a type of payment such as a grant or a capital payment. Managers focused on budget and legal compliance rather than on managing resources efficiently and effectively. The accounting system for the whole of government, including state-owned enterprises, was entirely cash-based.

The previous cash-based system had several deficiencies, some of which were highlighted by the country's reform agenda. According to officials and experts, the cash-based system was not providing crucial financial data on assets and liabilities to support the government's "ownership" role and created incentives for poor resource management. Further, the government did not know the full cost of producing a good or service, which was fundamental to the government role as "purchaser" under a more decentralized management regime.

According to New Zealand officials, under its previous cash-based system the government did not know what assets it owned, the value of these assets, and whether these assets were being put to the best use. For example, when officials in the 1970s wanted to sell spare land holdings,

they could not identify what land the government owned. The New Zealand cash system did not account for future liabilities arising from present commitments. The New Zealand government in the late 1970s provided guarantees to industries engaged in activities such as oil production aimed at reducing the country's reliance on foreign sources. The guarantees cost the government of the day nothing; however, as oil prices fell, industries withdrew from those sectors and redeemed the guarantees. Subsequent governments had to pay the high costs of those commitments made by earlier governments. Similarly, the cash accounting system was arbitrary in its application of specific principles. For example, under the cash system, the calculation of the deficit included the effect of interest rate changes on the cost of servicing government debt, but did not incorporate the effects of exchange rate changes on the value of the debt. Accordingly, when the currency declined in value, the value of the debt in New Zealand dollars increased, making the debt more expensive. Because the cash basis failed to account for this effect, the government continued borrowing in low-interest rate, strong-currency markets, without appropriate consideration and accounting for the risk involved in currency changes.

Another rationale for moving the entire public sector to accrual accounting and budgeting came from the improvement in the performance of state-owned enterprises (SOE) when they adopted accruals. These entities had in the past produced no return to the government. After corporatization and the implementation of accrual accounting and budgeting, these entities started producing profits.[4] By 1992, SOEs were paying more than NZ$500 million in dividends, which were used to improve the fiscal position of the government. According to government officials, improvements in this sector were seen as an indication that management efficiencies could be achieved by moving departments to accrual accounting and budgeting as well.

The final impetus, however, lay in the desire to tie budgeting to performance and accountability in a coherent framework. In this regard, a New Zealand government official stated that "there is much more to recommend the development of accrual accounting in government when it is implemented in the context of a regime which encourages management

[4]As extensive reforms occurred to SOEs at about the same time, it is difficult to draw a clear distinction between the benefits of corporatizing—putting SOEs on a commercial basis and forcing them to compete with private sector entities—and switching to accrual budgeting and accounting.

performance." In the new environment, the government defines strategies, which ministers translate into performance requirements (outputs) of the chief executives of departments. Under the reformed system, the government purchases these departmental outputs at an agreed upon price. Thus, output pricing is crucial. To properly determine the output price, the government needed to account for all output costs, not simply the cash flows in any given year. According to an architect of the New Zealand system, the accrual framework was chosen not "because it was better accounting, but because it was an integral part of the management framework" that the government was trying to install.

According to officials we interviewed, once the decision was made that accrual information would form the basis of reporting, they viewed it as crucial that it also become a key budgetary tool. A former official who was a key champion of the adoption of accrual budgeting stated that "accrual accounting for the whole of government will not amount to much more than an interesting accounting exercise unless the information is used for the purposes of economic management." Officials in New Zealand did not believe that accrual-based financial reporting alone would create incentives to manage programs more effectively. Further, they noted that even departments that were able to prepare financial statements had no incentive to do so unless they formed the basis of accountability, by tying actual performance to what was expected as represented by the budget.

Officials we spoke with also stressed the importance of following existing, widely accepted private sector standards. They pointed to relatively few exceptions where private sector standards failed to meet public sector needs. Such standards are preferable because they increase accountability by ensuring that more people would be informed and able to scrutinize the financial position and performance of the government.

The Audit Office provides its opinion on the financial statements through audit reports.[5] In addition, the Audit Office is heavily involved with the Treasury in the development of the accounting policies of the Crown. Financial statements of SOEs and Crown entities are audited separately,

[5]The Public Finance Act of 1977 established the Audit Office to provide independent information, assurance, and advice to Parliament. The office's current functions include performing and reporting on results of audits of financial statements and service performance information, and reporting on matters arising from audits generally. In addition, the Audit Office undertakes special audits regarding matters of concern identified by select committees, the public, or the Audit Office itself.

and their results of operations are reported in the Financial Statements of the Government of New Zealand.

Summary of Accrual Budgeting System

The New Zealand system makes a distinction between two roles of government: as purchaser of goods and services and as owner of assets used to provide those goods and services. Given its dual role as owner and purchaser, the government is not only interested in the services that are being rendered, but also the maintenance of an asset base to ensure the sustainability of these services. New Zealand's accrual-based framework encompassing output-based budgeting and accrual-based measurement in both financial reporting and budgeting is viewed as crucial in providing the information and incentives needed to make this dual role work.

Structure of Appropriations

Appropriations are generally limited to 1 year, consistent with the annual budget cycle, and cover proposed expenses.[6] Multiyear appropriations are rare and arise when Parliament wishes to signal a commitment that requires appropriations for more than 1 year. As shown in figure 10, the government's budget is presented by three primary statements similar to those found in private sector reporting: the Forecast Statement of Financial Performance, the Forecast Statement of Financial Position, and the Forecast Statement of Cash Flows.

[6]However, since appropriations cover noncash expenses such as depreciation, departments may carry cash balances.

Figure 10: The Three Primary Statements Used to Present the Budget

Forecast Statement of Financial Performance reports estimated revenues and expenses by major revenue classes and by functional classification, respectively. The operating balance is defined as revenues less expenses of departments, plus the results of operations (less any dividends) from SOEs and Crown entities. The statement also reports on actual financial performance for the previous fiscal year, as well as forecast performance for the 3 upcoming fiscal years.

Forecast Statement of Financial Position shows estimated assets and liabilities as of the end of the fiscal year. The statement also reports on actual financial position for the previous year, as well as forecast position for the 3 upcoming years.

Forecast Statement of Cash Flows shows the cash inflows and outflows for the budget year, the previous year, and the 3 upcoming fiscal years. The statement also provides a reconciliation between the forecast operating balance and the forecast net cash flows from operations.

In addition, the government also submits the Forecast Statement of Borrowings, the Statement of Commitments, and the Statement of Actual Specific Fiscal Risks. The Statement of Borrowings reports on the net debt of the government. The Statement of Commitments reports on the commitments of the government for future years, broken down into capital commitments, such as military equipment, and operating commitments, such as noncancelable leases.[7] These statements provide aggregate data at a high level, while the Estimates of Appropriations that accompany the above statements break down the budget request to detailed objectives and outcomes of the government and provide details on departments' and agencies' outputs. As shown in figure 11, there are seven types of appropriations. The funding request for each appropriation reflects the results of the purchase agreement between department executives and ministers, whereby the latter define the output to be provided and specify the quantity and quality. While department managers and ministers have authority to shift resources within each type of appropriation as long as they deliver the agreed upon outputs, ministers do not have the authority to transfer resources between types of appropriations without the consent of Parliament.

[7]This statement does not provide estimates of commitments for social insurance, which operates on a pay-as-you-go basis out of general revenue.

Figure 11: The Seven Types of Appropriations

Outputs: for classes of outputs to be supplied by departments and purchased by the Crown from other organizations or persons.

Benefits: for programs such as unemployment that departments have no direct control over, but administer on behalf of the government.

Borrowing expenses: for payments of interest, premiums, borrowings, and other finance costs.

Other expenses: for costs that could not reasonably be passed on to a third-party, such as restructuring costs, litigation costs, and loss on sale of fixed assets.

Capital contributions: for any increase in departments' net asset holdings or an investment of capital into an SOE, a crown entity, or an individual (e.g., a student loan).

Purchase or development of capital assets: to fund activities related to assets undertaken by the Crown, such as construction of state highways, national parks, or Parliament buildings.

Repayment of debt: to repay debt of the Crown.

Appropriations are provided for the total cost of outputs, including salaries and wages, as well as other costs not requiring cash outlays, such as depreciation. The cost of output also includes a cost of capital charge—akin to an interest charge for using capital—levied on departmental net assets to reflect the full cost of government services and to create an incentive to (1) more efficiently use assets and (2) dispose of surplus assets by making it more expensive to own assets of low utility.

Treatment of Specific Budget Items

As mentioned above, the treatment of budget items follows generally accepted accounting practices. This means that assets are capitalized and depreciation expense recorded over the life of the asset. Liabilities are recorded when they become probable and measurable. Our review, including interviews with New Zealand officials, showed that specific budget items are treated as follows.

- **Public sector employee pension**: Under accrual budgeting, each department transfers an actuarially derived amount equal to future pension benefits earned during the year to the Government Superannuation Fund, i.e., the Public Employee Pension Fund. This

amount is recorded as an expense on each department's financial statements and budget. The accumulated total of each department's expense is recognized as an expense (a debit) on the government's Statement of Financial Performance. A corresponding liability (a credit) is added to the existing pension liability from past services already recorded on the Statement of Financial Position, while cash outlays to current pensioners are recognized as reduction to pension liability. The movement in pension liability thus reflects the combined effects of cash outlays and current expense.

- **Capital**: New Zealand's appropriation for capital is divided into two categories: (1) appropriation for any increase in departments' net asset holdings, and (2) appropriation to fund activities related to assets undertaken by the Crown, such as construction of state highways, national parks, or Parliament buildings. New Zealand's cash appropriation to departments includes funding for noncash items such as depreciation expense. Managers have the freedom to optimize their asset base, which includes purchasing replacement assets by using funds accumulated from this depreciation expense. Managers with adequate reserves have the discretion to purchase assets up to a NZ$7 million limit, while those seeking to purchase assets between NZ$7 million to NZ$10 million must seek ministerial approval, even if they have enough reserves. Departments with inadequate funds to replace assets must request a capital injection—an appropriation for the difference between funds required and available reserves. Asset purchases over NZ$10 million must receive Cabinet approval, whether or not departments need a cash injection. To further encourage better management of assets, the government implemented a cost of capital charge on the net assets of the department. The capital charge is used to derive the cost of the output, thus the cash appropriated to departments includes the capital cost. Assets undertaken by the Crown are managed by departments on behalf of the Crown. In these instances, departments receive cash appropriation for the administrative costs of managing these assets, and not the depreciation expense, as decisions to replace these assets are made by the Crown and not by individual departments.
- **Inventories**: Inventories are recorded as assets in accordance with generally accepted accounting practices at the lower of cost or net current value, with appropriate allowances for obsolescence.

- **Insurance, loans, and guarantees**:[8] The Accident Compensation Corporation, New Zealand's major insurance program, covers all types of insurance including motor vehicle, on-the-job injury, and others. Starting with the fiscal year 1999-2000 budget, accident insurance is recorded on an accrual basis in the budget. An expense is recorded at the net present value of the estimated cash outflows of claims filed during the year, plus a small estimate based on historical data on the value of accidents that had occurred but had not been filed in the year. For fiscal year 1999-2000, the government also booked, in its Statement of Financial Position, a change in the Crown balance due to the recognition by the Accident Compensation Corporation of the estimated liability from past accidents. Loan programs are appropriated to departments as a capital contribution. Loans are recorded on the Statement of Financial Position at the recoverable value that includes an estimate for uncollectibles. Bad debt expense is recorded the year the loan is issued.
- **Social insurance**: The old-age pension program operates on a pay-as-you-go basis out of general revenue. New Zealand does not report a liability for commitments for this program.
- **Revenues**: Revenues are measured on an accrual basis and recognized at the point the debt to the Crown arises, for example, when an individual or company earns income that would be subject to tax. This means that taxes on income or goods and services that are deducted directly at the source are recognized when the transaction is forecast to occur. Other taxes are not recognized until an assessment is made by the revenue department or filed by the individual or company. The power to tax is not recognized as an asset because the criteria for recognizing an asset is not properly satisfied since the transaction that gives rise to the revenue has not occurred, nor could its value be measured reliably.

[8]Better disclosure of contingent liabilities helped point out the risk involved with the provision of government guarantees. Currently, guarantees are not a material item on the government's balance sheet.

Aggregate Budget Measure

Multiple measures are used to evaluate New Zealand's fiscal position. The primary measures are the operating balance,[9] the debt to GDP ratio, and net worth. The operating balance became one principal measure of the fiscal position when FRA made mandatory the use of accrual accounting standards for fiscal forecasting purposes. Under FRA, the government is required to present, in every budget, 3-year projections of government finances using the three principal financial statements described earlier. By requiring accrual-based budgets for the current year as well as the forecast budgets, FRA's intent was to increase both the transparency and credibility of the public accounts. The main differences between the accrual operating balance and the traditional cash balance are depreciation, changes in the pension liabilities of public employees, changes in working capital such as receivables and payables, and changes in the valuation of forests owned by the Crown. In addition, except for gains or losses, the accrual operating balance excludes the cash effects from the purchases or sales of assets.

In addition to the operating balance, New Zealand also emphasizes the debt to GDP ratio—a cash measure—as a key indicator to track the government's impact on the economy. According to government officials, the reason for focusing on debt was because a small and open economy like New Zealand needs to attempt to maintain a low debt to GDP ratio to be able to respond to future economic shocks. Officials and experts we interviewed explained that setting a debt to GDP ratio guided the subsequent determination of the operating balance. It also helped keep the government focused on maintaining surpluses and in articulating the need for running sustained operating surpluses.

[9]The operating balance is an accrual measure of the results of the operations of the New Zealand government for a fiscal year. It is the difference between revenue, calculated on an accrual basis, and expenses, also calculated on an accrual basis. The accrual operating balance is derived through inclusion of transactions such as depreciation and revenue receivable. Although these transactions did not result in cash outlays or receipts, they were the results of current year's operations.

Net worth, i.e., the difference between assets and liabilities, was also used at times to gauge fiscal performance. According to government officials, the changes in net worth allow government officials and other experts to analyze the government's fiscal performance over time. An increasing net worth can indicate improved financial position, while a decreasing net worth may signal the need for government to take actions to address shortfalls in assets or increases in liabilities. Furthermore, changes in net worth may be used to assess the fiscal sustainability of government programs because liabilities used to calculate net worth reflect the estimated commitment that the government had made in the past.[10]

Key Differences Between Accrual and Cash

Figure 12 shows the reconciliation between the operating balance and the adjusted financial (cash) balance. Key differences between accrual and cash relate to the timing of the recognition of revenues and expenses. The greatest timing difference between accrual and cash occurs in the recognition of pension expense, depreciation expense, and the purchase of assets. Timing differences mean that the bottom line—the surplus or deficit—is affected in either direction by accrual or cash depending on the activities undertaken by the government in a particular year. For example, cash outlays for the purchase of assets decrease the surplus (or increase the deficit) in the year the cash is paid under a cash system, but have no effect under an accrual system. In succeeding years, as the asset is put into service, depreciation expense decreases the accrual-based surplus (or increases the accrual-based deficit), but has no effect on the cash balance. In most instances, because the cash basis tends to recognize large capital items all at once while the accrual basis spreads the cost of purchases over the useful lives of the assets, accrual measurements generally smooth out expenses if capital purchases are not made at a constant level year after year.

[10]As noted previously, this does not include social insurance commitments.

Figure 12: Reconciliation Between Operating Balance and Adjusted Financial Balance (Cash)

Operating Balance (Accrual)
+/- Changes in noncash expenses (statement of financial performance):
- + Depreciation
- +/- Unrealized losses/(gains)
- +/- Net deficit/(surpluses) attributable to SOEs and Crown entities
- +/- Net losses/(gains) on foreign exchange
- +/- Increase/(decrease) in pension liabilities
- +/- Other noncash items (e.g., cost of capital)

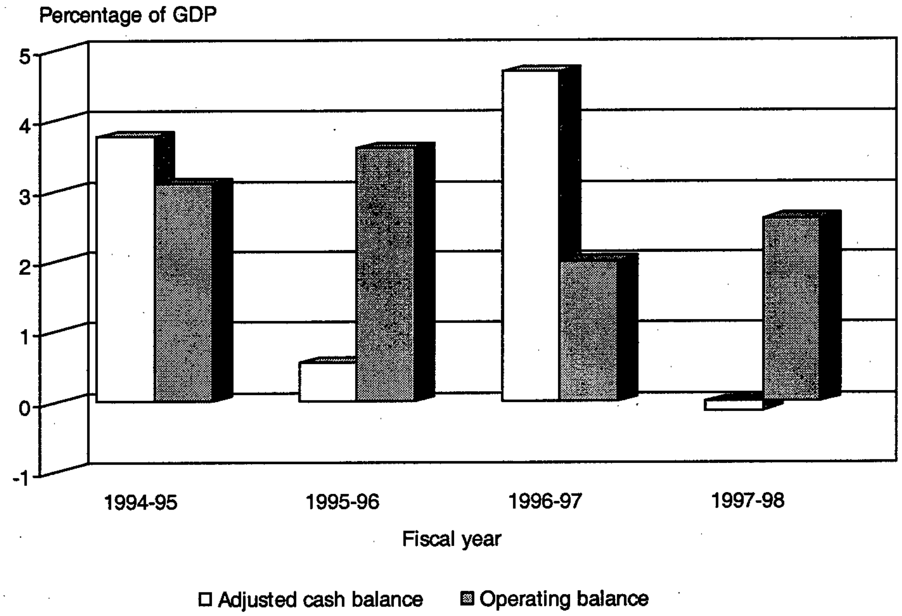
+/- Movements in working capital (statement of financial position):
- +/- Decrease/(increase) in taxes receivable
- +/- Increase/(decrease) in payables
- +/- Decrease/(increase) in other receivables
- +/- Decrease/(increase) in inventories

+/- Other items
- +/- Sale/(purchase) of assets
- +/- Other investing items

= Adjusted Financial Balance (Cash)

During the period from fiscal year 1994-95 through fiscal year 1997-98, the accrual operating balance differed from the cash balance, but the differences varied in magnitude and direction. In fiscal year 1995-96, the accrual operating surplus exceeded the cash surplus by about 3 percent of GDP, with the difference attributable in part to the purchase and sale of investments. In fiscal year 1996-97, the government achieved a cash surplus that exceeded the accrual operating surplus by almost 2.7 percent of GDP, due primarily to the sale of physical assets. In fiscal year 1997-98, the government actually achieved an accrual operating surplus but was in cash deficit, primarily because of purchases of investments and physical assets (see figure 13).

Figure 13: Accrual Operating and Adjusted Cash Balances, Fiscal Years 1994-95 Through 1997-98



Note: In 1994, the New Zealand government changed its definition of surpluses/deficits from a cash basis to an accrual operating balance basis. The adjusted cash balances from fiscal years 1994-95 through 1997-98 are our calculations and reflect the cash flows from operating and investing activities, which approximate the adjusted financial balance used to measure surpluses/deficits prior to 1994. However, some additional adjustments are necessary to arrive at an exact measure of the adjusted financial balance.

Source: *New Zealand Treasury.*

Views on Implications for Decision-making

It is difficult to isolate the effects of the adoption of accrual budgeting from those of the extensive public sector reform that occurred in New Zealand. It is also difficult to determine whether benefits attributed to accrual budgeting would have occurred with accrual accounting alone (i.e., without accrual budgeting). Since the New Zealand government never considered budgeting and accounting on different bases, when officials spoke of the benefits of accruals, they usually were referring to the benefits from both accrual accounting and budgeting. Some of the benefits for fiscal and managerial decision-making attributed to the accrual framework included

- encouraging more fiscally responsible decisions through better recognition of assets and liabilities;
- providing better information and incentives for asset management by recognizing the cost of capital asset use through the depreciation and capital charging regime;
- enabling departments to make efficient decisions when faced with a budget squeeze by improving cost recognition, thus helping to pinpoint inefficiencies; and
- encouraging better financial reporting discipline and the development of modern financial practices and systems.

As discussed later in this section, some critics have voiced concerns that managers have too much flexibility to make decisions that properly belong in the legislative arena. Others felt that the change in the basis of reporting and the emphasis on accrual rather than cash made it more difficult to assess the government's impact on the economy. Further, some disagreed that accrual budgeting improved transparency, noting that the use of accruals requires a more sophisticated understanding of financial issues because accrual measurement is based on technical standards and underlying professional judgments and assumptions.

According to a former minister, the greatest impact on fiscal policy from the introduction of the accrual framework has been to emphasize issues of sustainability by bringing greater attention to liabilities. In his view, recognizing and recording a long-term liability on the balance sheet causes greater fiscal caution and budget discipline. Under the cash budgeting system, parliamentarians were generally aware of the consequences of actions that have a future impact on the budget, but without the reporting requirement for liabilities embodied in accrual accounting standards, politicians were able to discount the magnitude of future liabilities in favor of funding current popular programs. For example, under the previous system the magnitude of government commitments to public sector pensions was recalculated and reported to Parliament every 5 years. However, since the liability was not a current estimate, it did not play a significant role in the budget debate. Consequently, politicians did not use it to argue convincingly for fiscal prudence when pushed by employee representatives to expand program benefits. Reporting the liability on the balance sheet annually as required by accounting standards made the long-term commitment more visible, and gave the government support, grounded in analytical data, for making difficult decisions. This former high-ranking official also told us that recognizing more than NZ$7 billion of public sector pension liability raised concerns in the government about the sustainability of the program. Subsequently, the government first refused to increase benefits and later closed the centrally operated, defined-benefit plan to new employees.[11] Similarly, the government ceased offering earthquake insurance to businesses once the liabilities of the program were reported on the balance sheet.

On the managerial side, current officials credited accrual-based budgeting with generating better information and creating the proper incentive for better asset management. To create the beginning balance sheet, an extensive exercise was conducted to find and value government assets. The exercise confirmed that where records of assets existed, they were woefully inadequate. Some organizations, such as the Department of Education, found assets that they were unaware of owning. While the most valuable assets were land and buildings, departments also found they had significant other assets. For example, the asset identification exercise found that unpaid fines due to the Department for Courts were a significant asset to that department's balance sheet. Subsequent attention prompted

[11]The government allowed departments flexibility to offer pension plans in wage negotiations, as long as they were defined-contribution plans.

the department to actively manage this asset by replacing the traditional collection methods with direct payment systems at courthouses and computerized call centers for tracking slow payers.

In addition, officials viewed the introduction of the capital charge as a significant incentive for better asset management. As mentioned previously, while the department is appropriated the capital charge as part of the price of its output, it must pay the cost of capital back to the government. If a department has a smaller asset base at the end of the year than the asset base for which the appropriation was made, the department is permitted to keep part of the capital charge. The consensus among officials we interviewed was that the capital charge had substantially reduced the amount of idle assets held by departments. However, other analysts argued that the capital charge might have driven department executives into making rational short-term decisions that could be damaging to the long-term sustainability of departmental operations. For example, an audit official informed us that partly to avoid a higher capital charge, one department has not replaced its assets, but instead has continued to operate with obsolete and fully depreciated assets, a move that enabled it to service more clients in the short run, but compromised its ability to deliver the best service in the long run.

Recognizing depreciation as an expense in the budget also was cited by some supporters of accrual budgeting as changing decision-making to result in more efficient asset use. Because departments are paid to produce outputs, the government has taken a hands-off approach on how departments manage inputs to produce those outputs. Since output prices are revised only periodically, departments may receive appropriations covering depreciation on assets that have been totally depreciated or assets that have been disposed. If a department is able to reduce an input cost such as depreciation expense while its price level stays the same, it can save that money to fund future replacement of an assets, or alternatively, it may use that money to fund other expenses such as additional personnel or salaries.

Others, however, expressed skepticism about the desirability of a depreciation regime. Some felt that giving managers the discretion to apply reserves built from depreciation expenses toward asset replacement amounted to giving executives too much freedom to make allocation decisions.[12] Others felt that the depreciation regime might impede efficient replacement of assets.[13] For example, officials in the New Zealand Defence Force informed us that in a technology-intensive environment, asset prices tend to increase commensurate with improving technology. In this environment, accumulated depreciation would never be adequate to fund asset replacement, thus requiring capital injections in almost all circumstances.

Some officials noted that adopting accrual-based budgeting was also valuable in ensuring fiscal discipline and improving the ability to maintain surpluses. Since 1991, New Zealand has maintained the core budget of each department at a constant nominal level, allowing almost no room for increases. Departments desiring additional funding had to deliver additional output or present convincing arguments as to why they could not extract additional efficiency from their organizations. According to a former Finance Minister, under a cash system the government could arbitrarily impose a budget squeeze on departments, but that could also cause arbitrary cuts to otherwise crucial programs. In contrast, because of the availability of cost information in the accrual budgeting framework, officials were able to identify and either cut or improve the efficiency of less efficient areas instead of sacrificing an area that was fundamental to its ability to deliver agreed upon outputs. While this is the generally accepted theory, some New Zealand experts have raised concerns that departments may have reached the limits of their abilities to “squeeze out” efficiencies and have begun to run down their capacity—by failing to replace or maintain both physical and human capital—in their drive towards efficiency.

[12]In New Zealand, decisions about individual asset purchases are made by the executive government and approved at an aggregate level by the legislature.

[13]According to Treasury officials, departments that did not efficiently and effectively replace assets could face operational difficulties, which could result in sanctions for their chief executives for poor performance.

In general, economists we interviewed felt that the new framework provided useful information to analyze the government's effectiveness in managing the country's finances. However, some said that the accrual accounting and budgeting framework, particularly the focus on the net operating balance and output appropriations, fails to provide adequate information with which to make informed analysis about the effect of government policies on specific sectors of the economy. Although the cash flows statement provides data on cash inflows and outflows, these data are available only on an aggregate level. Consequently, analysts informed us that they were unable to determine how much cash was spent, for example, on the transportation sector, and thus they were unable to determine the effect that such spending had on economic growth. These analysts believed that sector-specific details on cash inflows and outflows, as were provided under the cash basis, would greatly assist them in analyzing the effects of government spending.[14] Others told us that using net worth to measure sustainability was flawed because (1) the objective of the government is not to operate at a profit, (2) some government assets are difficult to value, therefore net worth may be misstated, and (3) a focus on net worth tends to direct the government towards implementing financial rather than fiscal policies. A former Secretary of the Treasury responded that the debate on whether cash or the accrual-based operating balance should be used to measure fiscal position is based on the "misplaced desire to look at accrual accounting information as if it were the be-all and end-all to fiscal management, instead of looking at accrual as another set of data that facilitates exercises on comparability." Officials acknowledged that an accrual-based net worth number is necessarily based on some underlying assumptions and professional judgments. However, they emphasized that what is most important is not the absolute level of net worth, but the ability to track trends in net worth as an indicator of the government's fiscal condition using consistent standards. Further, officials stressed that the government continues to monitor its cash needs through the cash flow statement.

Parliamentarians we interviewed were generally supportive of the new accrual framework and welcomed the additional information it provided. While most admitted to not fully understanding the intricacies of accrual, they generally felt comfortable with accrual principles and the quality of information provided. However, some expressed concerns about

[14]New Zealand officials countered that information on the cash flows of each entity is published annually and can be extracted and collated by private sector analysts.

accountability under an output-based appropriation framework because defining output is complex, and departments have incentives to revise those definitions, so that tracking accountability can be difficult.

Treasury officials believed that reporting under the accrual budgeting framework enhanced accountability. According to these officials, financial systems were no longer designed in house; instead, departments acquired modern, off-the-shelf financial systems to enable them to provide sophisticated financial information to the Treasury in a timely manner. Such information, which is now available each month, allows analysts to conduct financial analysis and provide early notice of departments at risk of not meeting their output agreements. In contrast, under the previous system, financial data were not available until the end of the fiscal year and indications that a department may be at risk of breaching its cash appropriation were not available on a timely basis.

Implementation Issues

Implementation issues in New Zealand can be organized into three groups: (1) transitional issues, which relate to timing, skills, and resources necessary to implement accrual, as well as issues related to asset identification and valuation, (2) issues that relate to accountability and parliamentary control, and (3) ongoing challenges, including output pricing, asset management, and the capital base.

Transitional Issues

Officials told us that although timing, skills, and resources to implement accrual budgeting were initially considered problematic, they were generally resolved without too much difficulty. According to a former Treasury official, though the targeted transition period was considered optimistic, all departments made the transition to accrual within the time frame specified. In addition, though departments were not given additional resources to fund the development of new accounting systems but instead were expected to recoup the cost from efficiency gains, freeing departments from the cumbersome regulations of the old cash process was one such source of efficiency gain. In addition, the new integrated accounting system substantially reduced processing and reconciliation problems, thereby freeing resources for other purposes.

A major challenge throughout implementation was to ensure that the opening balance sheet was as accurate as possible. The accuracy of the balance sheet was particularly important given that it provided the foundation for amounts, such as depreciation and capital charges, that

under the new regime were to be included in the budget. Since government entities were previously less concerned with managing assets, the existing information on both the ownership and valuation aspects of assets was inadequate. Departments and auditors found it particularly difficult to ensure that all properties were reported. Officials explained that there was a lot of fine-tuning of the reported asset values in the early years of implementation, but that the problem was substantially resolved after several years of experience.

A key factor in the successful move to accrual budgeting was the strong support both from the political leadership and within the bureaucracy. Politicians' needs for better financial and managerial information provided the impetus behind the passage of the Public Finance Act of 1989, with decisionmakers committed to ensuring that the implementation was successful. Once departments realized that performance management, and the accompanying accrual framework, was not going away, momentum for its implementation was established. Peer pressure was brought to bear, as chief executives operating under 5-year contracts had an incentive to ensure that they quickly and effectively transitioned to the new environment.

Officials also attributed implementation success to the adoption of private sector accounting standards. Whereas in the past, budget officials received special training in cash budgeting, now a larger pool of potential employees exist who have already been educated in the common accounting standards used in both the public and the private sectors. In addition, managers were given more freedom to hire from this larger available human resources pool.

Parliamentary Accountability and Control

Ten years after implementing accrual budgeting, tension continues to exist between accountability and control. At its core, the accrual-based framework was designed to give more flexibility to managers in exchange for more information to Parliament and the public. However, discussions continued as to how much decision-making freedom to give managers. One issue that illustrates the tension between managerial autonomy and parliamentary control is the proposal that departments be able to retain surpluses achieved through efficiencies and cost reductions. From a managerial standpoint, being able to retain surpluses increases the incentive to be more efficient, more innovative, and more results-oriented. From the point of view of Parliament, retention of surpluses undercuts one of the fundamental principles of public expenditure, i.e., that money is

appropriated for specific purposes. While using its efficiency gains to provide more of its own output may be desirable from a department's point of view, it may not be in the collective interest for the government to devote the department's efficiency gains to that output because priorities may lie elsewhere. For example, there is no governmentwide policy to reinvest savings in the same area where the savings were made. Government reserves the right to invest departmental savings in other high priority areas. Experts we interviewed admitted that this continues to be a difficult area to resolve.

Another area that illustrates the tension between parliamentary and managerial control is capital, specifically the question of who should decide the proper mix of capital. From a managerial standpoint, depreciation measures the cost of resource consumption. However, providing depreciation expense to departments in the form of cash is tantamount to giving free rein to managers, who may elect to use the funding to finance other activities in the short term. Under the cash system, parliamentarians through their legislative authority to appropriate funds could determine whether and when asset purchases could be made. Under the new environment, they no longer play this role.

Output pricing is another area that not only presents practical implementation difficulties, but also has implications for parliamentary control. Some officials in the legislative branch felt that the focus on output instead of input controls might provide opportunities for departments to mask data. This is because the new reporting framework does not routinely provide information on the mix of input used to produce each specific output. For example, social work services to children and young persons is one output requiring an appropriation of almost NZ$190 million. Although the output is defined by various performance standards, such as the number of notifications investigated or the number of orders in force, the appropriation documents provide no detail as to the mix of personnel, overhead, or technology used to provide the output. Consequently, it can be difficult to determine whether an output was achieved by extracting efficiencies, or by running down and not replacing needed assets. Furthermore, as departments redefine outputs over time, the lack of input information makes it even more difficult to compare performance on a consistent basis. In addition, output classes are inconsistent—some are broad, whereas others are detailed—making meaningful comparisons within and across departments challenging. While Parliament has tried to better monitor performance and sometimes relied on auditors' reports,

officials cited difficulties in achieving optimal oversight over departments that have been given a great degree of managerial discretion.

Ongoing Implementation Challenges

Issues related to output pricing, asset management, and the capital base represent ongoing challenges to government officials. New Zealand's accrual-based budgeting framework is premised on the ability of government in its purchaser role to adequately assess the price and quality of outputs. However, while pricing outputs for state-owned enterprises is possible because private sector comparisons can be made, pricing outputs for unique government services that have no comparable alternative in the private sector continues to present a tremendous challenge. In instances where prices could be derived, judging the quality of the output produced presented additional challenges. For example, although it is possible to accumulate the cost of policy advice across government for comparison purposes, the quality and relevance of such advice is harder to evaluate. It is thus difficult to judge when a price is right, when the price is too high, or when the price is too low.

Asset management was also cited as a difficult area. According to several Treasury officials, the difficulty arose from the decision not to optimize the asset base at the time of the switch to accrual budgeting. Because the new framework assumed that departments started out with the capital necessary to ensure sustainability of their activities, departments found it difficult to argue for capital injections to purchase additional assets, thus discouraging departments with legitimate capital needs from seeking additional appropriations. Over the last several years, we were told, major equity problems have arisen. Departments that were asset-rich when the new system was implemented were able to maintain and even expand their asset bases, thus delivering quality service. Asset-poor departments have continued to run down their asset bases. Officials found that some asset-rich departments have been able to install up-to-date computer systems because they accumulated depreciation funding. In contrast, an asset-poor department that could not accumulate much depreciation funding did not have an adequate computer system and therefore no longer maintained information on its caseload on-line. Officials also warned that several departments were not able to accumulate adequate depreciation expense to fund new assets, and therefore had continually run down their assets and would require capital injections in the near future.

United Kingdom

The United Kingdom's shift to accrual reporting and budgeting has progressed over several years, coinciding with a series of broader reform efforts aimed at improving the nation's economic health and public management regime. The United Kingdom's accrual framework, known as Resource Accounting and Budgeting, applies commercial style accounting practices to central government financial reporting and to budgeting. Subject to Parliament's approval, resource budgeting is to be in effect from financial year 2001-02. As currently proposed, resource accounts consisting of five financial schedules prepared on an accrual basis are to replace the traditional cash-based appropriation accounts and become the main form of accountability to Parliament. Parliamentary approval for departmental funding is expected to operate on a dual cash and accrual basis.

Background

The United Kingdom is a unitary state composed of England, Scotland, Wales, and Northern Ireland.[1] There are two main levels of government—the central government and local authorities. The central government has direct or indirect control over most government revenues and spending, while local authorities are primarily responsible for service delivery in education, housing, and social services.

Governmental Structure

The government is a parliamentary system, with a Parliament composed of two chambers—the House of Lords and the House of Commons. The focus of parliamentary control lies with the House of Commons, which is comprised of approximately 659 elected members. It is responsible for the passage of legislation and scrutiny of public administration, with sole legislative responsibility for budget matters. The House of Lords has relatively limited powers in the legislative process and virtually no power with respect to budget matters. The government is headed by a Prime Minister, who is the leader of the majority party in the House of Commons, and an appointed cabinet of about 20 members, who are also members of Parliament. A general election is held at least once every 5 years.

Two political parties—the Labour Party and the Conservative Party—have dominated British politics. The current Labour government, headed by Prime Minister Tony Blair, was elected in 1997. Prior to Labour's taking power in 1997, the Conservative Party had held power since 1979.

[1]The government has devolved powers to Scotland, Wales, and Northern Ireland.

The Budget Process

The governing political party effectively controls the entire budget process. The Treasury serves as the primary control point for spending and tax decisions with the Parliament playing only a limited role in the budget process. The Parliament cannot increase the government's spending proposals and, in practice, has limited ability to do anything other than accept them.

The current Labour government recently modified the budget planning process. Total spending is split into two categories that have separate control mechanisms. The first category is subject to Departmental Expenditure Limits, which are set for 3 years and, unlike the old process, will generally not be reviewed annually. The second category, Annually-Managed Expenditures (AME), consists of spending that is more difficult to control. Its largest components include social security benefits, interest, and local government expenditure. Spending covered by AME will be subject to annual reviews and considered part of total spending for purposes of achieving the government's fiscal goals. The budget also includes an annual reserve that is intended more for emergency spending than as a source of supplemental funds for departments. The new budget framework also places a greater emphasis on distinguishing between current and capital spending.

The Economy and the Budget

Over the past two decades, the United Kingdom has experienced periods of deep recession and robust growth. After recovering from a deep recession lasting from 1979 to 1981, the economy experienced sustained growth with an annual average growth rate of more than 3 percent in real terms for nearly a decade before dipping into a recession again between 1990 and 1992. The economy began to recover during the second half of 1992 and has continued to expand since then.

During the past two decades, changes in the United Kingdom's fiscal position have closely followed the economic cycle.[2] From the mid-1970s to the mid-1980s, the United Kingdom had large budget deficits. Deficits gave way to surpluses during the 1980s expansion. Then, with the onset of the recession in the early 1990s, deficits reemerged before steadily declining in tandem with the sustained economic growth of the mid- to late 1990s.

[2] *Budget Surplus: Experiences of Other Nations and Implications for the United States* (GAO/AIMD-00-23, November 2, 1999) and *Deficit Reduction: Experiences of Other Nations* (GAO/AIMD-95-30, December 13, 1994).

The United Kingdom's net public debt, as a percentage of GDP, has fluctuated during the past two decades. The net debt to GDP ratio declined from approximately 70 percent in 1970 to about 45 percent in 1979 before increasing again in 1980. The net debt to GDP ratio declined again during the 1980s before increasing again until the late 1990s. The trend of increasing debt to GDP reversed itself, with net debt as a percentage of GDP falling to about 42 percent in 1998 and projected to decrease further to about 36 percent by 2003-04.

Recent Reform Efforts

Improving the efficiency and effectiveness of public sector performance has been a high priority in the United Kingdom for over a decade. The United Kingdom's early efforts to improve public sector financial management were launched in 1982 with the Financial Management Initiative that emphasized the devolution of responsibility for budget and financial controls. The country continued to embark on a series of reforms throughout the 1980s emphasizing improved performance management within the public sector.

Most recently, the Labour government has undertaken a series of reforms aimed at improving the health of the economy and the effectiveness, efficiency, and transparency of government activities. In June 1997, the government launched a comprehensive assessment of all government spending programs—both current and capital—with the aim of better aligning programs with government priorities and generating ways of improving efficiency and service quality. Additionally, as discussed below, the government plans to adopt a form of accrual accounting and budgeting, known as Resource Accounting and Budgeting (RAB), which was originally proposed by the previous government.

The Labour government also established a statutory basis for developing fiscal policy with a new law requiring the government to issue a "Code for Fiscal Stability." The purpose of the law is to increase the transparency of fiscal policy decision-making and to enhance accountability by requiring the government to present a fiscal strategy and meet certain reporting requirements. Although the Code for Fiscal Stability provides a general framework requiring that fiscal and debt management policy be guided by five key principles—transparency, stability, responsibility, fairness, and efficiency—it nevertheless allows the incumbent government wide discretion in developing its specific strategy.

The current Labour government's fiscal code establishes two rules: (1) the "golden rule" which prohibits borrowing to finance current spending and (2) the "sustainable investment rule" which requires that net public debt as share of GDP be kept at a "stable and prudent" level. Both rules are to be applied over the economic cycle, allowing for fiscal fluctuations based on economic conditions. These fiscal rules are meant to work together. The "golden rule" is intended to recognize explicitly the different economic nature of current and capital spending and is designed to ensure control of public finances while allowing deficit financing of capital investment, net of depreciation and asset sales.[3] At the same time, the "sustainable investment rule" recognizes that borrowing for public investment must be constrained by the need to ensure a "prudent level" of debt.

Use of Accruals in Financial Management

Timeline: Progression of Use of Accruals

The United Kingdom has progressively extended the use of accrual accounting (known as resource accounting) across government and is currently aiming to have accrual budgeting fully implemented for fiscal year 2001-02. Resource accounting applies commercial-style accrual accounting to central government departments. Additionally, it includes a framework for analyzing expenditures by departmental aims and objectives, relating them to outputs where possible. Resource budgeting refers to the planning, managing, and controlling of public expenditures, at both the departmental and aggregate levels, based on resource accounting techniques and information.

The then-Chancellor of the Exchequer launched the United Kingdom's move toward resource accounting and budgeting in 1993 as part of his budget proposals. In 1994, the Green Paper, *Better Accounting for the Taxpayer's Money*, set out the potential benefits of implementing resource accounting in departments and considered the case for adopting accruals for budgeting. A 1995 White paper confirmed the government's commitment to use resource accounting as the basis of public expenditure

[3]The government defines investment as "physical investment and grants in support of capital spending by private sector." See *Fiscal Policy: current and capital spending*, HM Treasury (United Kingdom), 1998, p. 7 fn. 2.

planning and control (budgeting). However, changing the basis of Parliament's voting of funds will require new legislation. A draft bill has been introduced for consultation with the hope of having final legislation by summer 2000.

Initial implementation efforts focused on developing the standards and information systems necessary for financial statement reporting. One of the first steps was determining appropriate reporting standards and requirements. After consultation with other government departments and other interested bodies, the Treasury produced a *Resource Accounting Manual* (RAM) that sets out the standards and policies to be used to guide the preparation of departmental resource accounts. The Financial Reporting Advisory Board (FRAB)[4] conducted a comprehensive review of and eventually endorsed the RAM. The Board is expected to continue to review the RAM and consider proposals for change based on experience, the evolution of generally accepted accounting practices, and development of policy aims with respect to RAB.

Over the past several years, departments have made progress in implementing resource accounting. For purposes of testing the new systems, the first resource accounts were to be produced for fiscal year 1998-99. Although not to be published, the National Audit Office (NAO)[5] was to audit these "dry run" accounts. Subject to departmental progress in preparing their accounts, audits were to be concluded in October 1999. NAO will advise the departments and through them the Treasury of their findings. The first full set of published resource accounts is scheduled for financial year 1999-2000. With a foundation in resource accounting, Treasury turned its efforts toward implementing resource (accrual) budgeting.

[4]Although the legislative authority to set public sector accounting standards lies with the Treasury, FRAB was established, on the advice of Parliament, to provide the Treasury with independent advice on developing and applying financial reporting principles and standards to the central government.

[5]NAO was established in 1983 to provide independent information, assurance, and advice to Parliament. NAO, which employs about 750 staff, is headed by the Comptroller and Auditor General. NAO carries out two main types of work: (1) financial audits that certify the accounts and include examining the regularity and propriety of government expenditure and addressing the risks to financial control and accountability and (2) value for money audits that review the economy, efficiency, and effectiveness of publicly funded programs, projects, and activities.

Factors Surrounding the Adoption of Accrual Budgeting

Reform efforts—within the United Kingdom and across the international community—set the stage for the United Kingdom's move to accrual budgeting. From the start of the United Kingdom's performance reforms, it became clear that it would be difficult to adequately assess "value for money"[6] under a cash-based system and attention turned to developing an integrated financial system that would more effectively support reform efforts by improving the quality and consistency of the information provided to decisionmakers. The recognition that the cash-based budget system was not fully reflecting the needs of performance management was bolstered by the increasing use of accruals elsewhere in the United Kingdom public sector and a general skepticism about the cash system, which was viewed as allowing manipulation of spending across years and creating disincentives for capital spending. Further, the movement of other countries to accrual budgeting was described as helping to provide United Kingdom officials "the courage" to undertake RAB.

As an outgrowth of the United Kingdom's long-standing public sector reform efforts aimed at achieving more efficient performance and better value for money, RAB's design reflects the central government's concern about improving performance measurement and the links between inputs and outputs. As described by one Treasury official, RAB is about more than changing the basis of calculating cost. It is as much about identifying the costs of aims and objectives and a more systematic use of output and performance measures which carries forward the Financial Management Initiative of 1982.[7] The government's new fiscal framework, especially its emphasis on distinguishing current and capital spending, was also viewed as further paving the way for RAB and providing a conduit to advance it not only as a "micromanagement" tool but as useful for fiscal policy.

The United Kingdom's Proposed Accrual Budgeting System

The RAB framework involves both a shift to accrual-based measurement and the linking of inputs to outputs (performance measurement). Both components—the change to an accrual measurement basis and the move to output-based reporting—are viewed as important to the design of RAB.

[6]"Value for Money" refers to the economy, efficiency, and effectiveness of publicly funded programs, projects, and activities.

[7]The Financial Management Initiative of 1982 emphasized the need for managers at all levels to have clearly defined objectives, responsibility for the best use of resources, and information particularly about costs and the achievement of objectives.

Structure of Appropriations

Under resource budgeting, resource accounts will replace appropriation accounts[8] and become the main form of accountability to Parliament. As proposed, parliamentary approval for departmental funding is to operate on a dual cash and "resource" basis. Each budget estimate will include

- several "requests for resources" which represent expenses on an accrual basis, including noncash amounts such as depreciation and a 6 percent charge on net assets employed, and
- a single cash requirement, built up from the resource requests and representing an absolute limit on the withdrawals from the Consolidated Fund.[9]

Thus, instead of cash alone being the budgetary measure, departments will have a resource budget in accrual terms and an associated cash requirement, known as the financing requirement. In comparison to the New Zealand and Australia models, which provide cash to cover noncash amounts such as depreciation, the United Kingdom's resource budget would treat noncash items as "notional" entries, i.e., departments will not receive cash to cover these amounts. Figure 14 shows, in general terms, the reconciliation between the resource budget and the financing (cash) requirement.[10] Similarly, overall planning totals will be the government's Resource Control Total and an associated Total Financing Requirement. While stressing that a number of issues, such as the precise treatment of capital, were still unresolved at the time of our visit, officials noted that a key objective in designing the resource budgeting system was to concentrate attention on resources while continuing to control cash.

[8]In the United Kingdom system, an appropriation account is an end of the year account that compares amounts authorized by Parliament with actual cash payments made and receipts collected and explains any substantial differences. One account is prepared for each vote. A vote is taken to provide funds for each individual "supply estimate"—a statement presented to the House of Commons of the estimated expenditure of a department.

[9]The Consolidated Fund is the account to which tax revenues and other current receipts not specifically directed elsewhere are held and from which payments for the largest part of central government expenditure are made.

[10]The financing requirement refers to the net cash implications of a department's resource budget. It is the cash limit that will apply to departmental spending.

Figure 14: Reconciliation of Resources to Financing Requirement

Department's Resource Budget

+ New capital spending
+ Borrowing permissions
- Capital charges (including depreciation)
-/+ Changes in working capital

= Department's Financing Requirement
(Broadly equal to net cash requirement)

The resource accounts for departments will consist of five schedules, including three that are similar to private sector statements, namely a Balance Sheet, an Operating Cost Statement, and a Statement of Cash Flows. The other two statements, which do not have direct private sector equivalents, include (1) a Summary of Resource Outturn[11] and (2) a Statement of Resources by Departmental Aims and Objectives. The Summary of Resource Outturn will serve as the statement for parliamentary control, highlighting the request for resources and the net cash requirement that are voted on by Parliament. It will provide reconciliation between requests for resources and the consequential cash requirement. The Statement of Resources by Departmental Aims and Objectives links resource inputs to department aims and objectives. In addition, but outside the accounts, a sixth statement—an Output and Performance Analysis—will show achievement against departmental objectives, major outputs, and overall efficiency of operations.

The use of resource accounts for budgeting is to be phased in over the next several years. The first resource accounts will be published for the fiscal year 1999-2000, and will be produced in parallel with the present cash-based Supply Estimates and Appropriation Accounts. The Treasury, subject to the approval of Parliament, then plans to implement resource-based budgeting for 2001-02, replacing cash-based appropriation accounts.

[11]The term "outturn" refers to actual expenditure and income.

Treatment of Specific Budget Items

At the time of our visit the Treasury was in the process of developing a resource budgeting manual to serve as an operational guide for departments in preparing their resource budgets. Because this manual was in the development stage, officials and staff we spoke with stressed that some of the implementation and control issues surrounding the treatment of certain items were not fully resolved. However, officials stressed that compatibility of accounting standards for use in the budget was and continues to be given considerable attention. According to Treasury officials, during the development phase, attempts were made to anticipate the accounting standards' capacity to support resource budgeting. In cases where the requirements of generally accepted accounting practices and the parliamentary control process are in conflict, the manual states that generally accepted accounting practices should be adapted accordingly. For example, officials noted that in order to coincide with the budget process the timing of asset valuations was adjusted.

The following summarizes the proposed treatment of key budget items.

- **Public sector employee pensions**: Under resource budgeting, each department will pay an actuarially derived contribution for annual employee pension costs to relevant pension schemes, resulting in an intragovernmental transfer. These pension contributions will be included in a department's request for resources and cash requirement. The centralized pension schemes receive these contributions from the departments and use them to make payments to current retirees. Thus, at the governmentwide level, the total financing requirement represents the total cash required for payments to current retirees in that year. If cash payments to current retirees exceed the departmental contributions, drawings are made from the Consolidation Fund to makeup the difference.

  For each pension scheme there will be a separate actuarial statement that shows total pension liability and the level of annual contributions (expressed as a percentage of pay) that departments need to make to meet the liability. However, this actuarial amount is not recorded in the pension funds' resource request or financing requirement.

- **Capital**: The purchase of new capital assets would require a cash appropriation for payments made in the fiscal year; this amount would be included in a department's financing requirement but would not be included in the resource budget. The annual cost of using capital, namely depreciation and a cost of capital charge,[12] would be included in

the request for resources as "notional" entries and would require a parliamentary vote but would not result in departments receiving cash. Thus, in comparison with the New Zealand model that provides cash to cover noncash amounts, such as depreciation and capital charges, with the expectation that departments will manage and use these funds to maintain their asset base, RAB was designed to help focus attention on the cost of capital use without significantly decentralizing cash and asset management. As shown in figure 14, under resource budgeting, the noncash amounts, such as depreciation, are backed out in order to get to the cash requirement.

- **Inventories**: Under resource budgeting, the cash requirement would include the payments estimated to be made during the fiscal year. The request for resources would include the amount of inventories estimated to be consumed during the fiscal year.
- **Insurance, loans, and guarantees**: These types of programs are limited in the United Kingdom and generally are outside the coverage of RAB. Loans made by departments to bodies not consolidated in their accounts will nonetheless be recognized as assets in resource accounts. The making or recovery of loans will be included in the cash requirement. Significant contingent liabilities are noted in the budget estimates and presented to Parliament and reported in notes to the accounts.
- **Social Insurance**: The National Insurance Fund, which covers unemployment, state retirement pensions, and part of the National Health Service, will not be covered by RAB. This fund is operated on a "pay-as-you-go" basis with the budget reflecting cash flows for the fiscal year. Any shortfall between collections and payments is paid out of Consolidated Fund revenues.
- **Revenues**: Under RAB, tax revenues will continue to be measured for the time being on a cash basis, primarily due to measurement difficulties and prohibitive implementation costs.

Aggregate Budget Measure

At the time of our visit, there was still uncertainty about the link between the RAB initiative and the measures focused on for fiscal policy. Corresponding to the introduction of its new fiscal policy framework, the Labour government introduced a new format for presenting fiscal policy measures. The new format is intended to more readily allow the monitoring

[12]The cost of capital charge is a charge on an entity's total net assets.

and assessment of progress against the two fiscal rules described above—the "golden rule" and the "sustainable investment rule."

The main changes under the new format are to better distinguish current and capital spending and to focus on a measure of budget balance that excludes financial transactions. Under the new format the three principle measures of public finances are as follows.

- **Surplus/deficit on current budget**: Under the new format, current receipts less current spending will be used to judge whether the "golden rule" will be met over the economic cycle.
- **Public Sector Net Borrowing (PSNB)**: Under the new format, the Treasury has switched to PSNB as the main overall budget measure. Prior to 1998, the main surplus/deficit measure was the public sector net cash requirement (PSNCR), referred to at the time as the public sector borrowing requirement.[13] PSNB differs from PSNCR by excluding privatization proceeds and other financial transactions.[14]
- **Public Sector Net Debt Ratio**: Under the new format, total debt of the public sector (net of certain liquid assets) as a proportion of GDP is used to judge whether the government's "sustainable investment rule" is met.

Although the interaction between the information provided under RAB and these measures has not been fully resolved, some Treasury officials speculated that the current budget surplus/deficit may be measured on an accrual basis once resource budgeting is implemented. However, they noted that a number of issues, such as the interaction of the RAB measure with national income account reporting, were still under discussion.

Key Differences Between Cash Versus Resource Budgeting

As noted above, the first resource budget is expected to replace appropriation accounts in fiscal year 2000-01. However, based on experience to date with resource accounting, the implications of resource budgeting are expected to be greatest for capital intensive departments, such as the Ministry of Defense, while other less capital-intensive departments, such as the Home Office, were not anticipating significant

[13]PSNCR includes receipts and expenditures at all levels of government, including privatization proceeds, and is similar to the United States' unified budget.

[14]Other financial transactions include loans made by the public sector and some other adjustments which reflect the precise timing of payments.

changes resulting from the budgetary change to accrual-based measurement.

Views on Implications for Decision-making

In introducing RAB, the Treasury asserted significant benefits for fiscal policy and managerial decision-making including

- making decisionmakers focus more on resources consumed and not just the cash spent,
- treating capital and current expenditure in a way that better reflects their different economic significance, and
- encouraging a greater emphasis on outputs and the achievement of aims and objectives.

According to the Treasury, RAB is expected to improve decision-making at both the governmentwide and the departmental level by ensuring that the "full economic costs of government activities are measured properly" through the inclusion of costs such as capital consumption and by matching costs to the right time period. [15] Another significant benefit credited to RAB is the improved integration of the full cycle of planning, budgeting, monitoring, and reporting.[16] Along these lines, a key official we spoke with stressed RAB's alignment of the basis of budgetary measurement with financial reporting standards that mirror private sector generally accepted accounting practices as critical to improving the transparency, consistency, and credibility of information and incentives for decision-making. Officials we spoke with stressed that they viewed having the ex-post financial reporting system and the ex-ante budgeting system on the same measurement basis as valuable for facilitating decision-making.

From a departmental management perspective, resource budgeting is anticipated to provide managers with better management information as well as improve the incentives to manage resources more effectively. Resource budgeting was viewed as particularly beneficial in two areas: improved asset management and better linkages between resources and

[15] *Resource Accounting and Budgeting: A Short Guide to the Financial Reforms*, Her Majesty's Treasury, January 1998.

[16] The Green Paper notes that "the consistency of departments' internal budgeting systems with the overall system of budgetary allocation and control within the government is a key objective."

outputs. Overall, the information and incentives under resource budgeting were described as having the potential to enable both department managers and policymakers to make better decisions about how best to use resources. For example, officials from the Ministry of Defence credited RAB with improving understanding of asset base and inventory levels, noting that these issues are being taken more seriously now that they will be directly linked to the budget. However, some we spoke with pointed out that resource budgeting would have the greatest implications for capital-intensive departments and would likely have significantly less impact on other departments. In addition, some of the benefits of RAB may result from improved financial accounting and linkages of resources to outputs rather than the change of budgetary measurement basis from cash to accrual.

Proponents also argue that resource budgeting will help ensure that the planning framework delivers the government's fiscal policy objectives. First, using departmental resource accounts to underpin resource allocation decisions at the aggregate levels is viewed as helping to ensure that allocations among the government's competing priorities are made in consideration of full cost information. Further, some officials suggested that resource budgeting will encourage a wider breadth of questions with respect to sustainability and efficiency than previously considered under the cash system. The Treasury noted that the government collectively will benefit because, what is good for departmental management is also good for the government as a whole. Finally, resource budgeting is viewed by some as supporting the government's investment objectives by spreading the cost of capital over its useful life and by clarifying the opportunity costs associated with holding capital through capital charging.

The direct implications of resource budgeting on parliamentary decision-making, however, are hard to discern. Parliamentary Committee Reports, while expressing some caution, articulated support for RAB noting the anticipated benefit of increased information for parliamentary decision-making. As expressed by the Clerk of the House, "the House, in general, and departmental select committees in particular, will welcome the greater range of information which will be provided in resource-based documents." However, despite these perceived benefits of improved information, both parliamentary staff and academics cautioned that the extent to which resource budgeting will influence parliamentary decision-making must be considered in the context of the Parliament's limited role in the budget process. As previously noted, Parliament has historically had a limited role in the budget decision-making process. Nevertheless, parliamentary staff

generally agreed with others that Parliament may benefit from RAB indirectly through improved management of departments and increased information for oversight.

Implementation Issues

At the time of our visit, Treasury and Parliament were beginning to address numerous implementation and control issues raised by the introduction of resource budgeting. Officials we spoke with acknowledged that because the RAB initiative was still in the early stages, some implementation and control issues remained unresolved. Some of the key issues surrounding the introduction of resource budgeting included the following.

Parliamentary Accountability and Control

The introduction of resource budgeting has raised concerns about the implications for parliamentary accountability and control. In particular, parliamentary committees have expressed concerns that the replacement of appropriation accounts may result in reduced understanding and weaken parliamentary oversight. In July 1998, the Committee of Public Accounts noted that a "main concern is that the current bases for voting Supply[17] and holding departments accountable should not be discontinued until it is clear that there are equally effective or better arrangements to replace them."

Parliamentary control concerns about resource budgeting have been intensified, at least in part, by the heavy reliance on professional judgment involved with the use of accrual-based measurement and other unresolved issues dealing with implementation specifics. A general concern was expressed that the movement towards accrual-based measurement will introduce a greater degree of professional judgment, and thus uncertainty, into the budgetary process than is presently the case with the cash-based system. Both parliamentary staff and NAO officials expressed concerns about the added level of complexity associated with accrual-based reporting. Some suggested that this added complexity could lead to the potential for manipulation. For example, whether a transaction is recorded in the budget will not simply be based on the timing of cash payment, but rather will depend on professional judgments about the timing of the consumption of resources and other underlying assumptions. Further, some issues surrounding how new assumptions will be integrated into the

[17]Voting supply refers to voting the budget.

budget process have not been fully resolved. For example, since budget amounts for departments are to be fixed for a 3-year period under the new fiscal framework, how will changes in assumptions surrounding depreciation and capital charges be handled in order to prevent departmental windfalls (excess funding)? Also parliamentary staff and NAO officials expressed concern about the ability to adequately track the linkages between the request for resources and the underlying cash requirement.

Transitional Issues

The government is taking a number of steps to smooth the transition to resource budgeting and to help mitigate concerns. Officials and program managers stressed that ensuring cultural change and training is critical to the success of resource budgeting. Treasury officials told us that numerous training efforts are being undertaken to support the implementation of RAB. Much of this training has been decentralized, with Treasury taking on a facilitating role while departments have responsibility for designing and implementing their own training programs. Additional implementation issues have focused on how to structure account presentations and voting procedures to provide sufficient assurance about cash control while focusing decision-making on resources. At the time of our visit, there were continuing efforts to clarify the treatment of more technical accounting issues in the budget context. Some Treasury officials, however, noted that a number of issues might not come to light until resource budgeting is underway.

In part because of these implementation challenges, the appropriate implementation timetable continues to be a source of debate. One Treasury official stressed that the goal has been to make the timetable long enough to allow for sufficient groundwork but short enough so that the initiative is taken seriously and the momentum is maintained. Some suggested that extending the dual running of the old cash system and the new resource-based system would allow time for increased understanding of the implications for parliamentary control and oversight. The Treasury, however, opposed additional dual running of the two systems, testifying that doing so would be extremely costly and would undermine incentives to move to the new system. To help allay fears the Treasury has developed a series of "trigger points" to assess department progress.[18] Departmental implementation concerns to date have focused on system and staff capacity.

NAO has been, and will continue to be, involved with monitoring department progress. In 1997 and 1998, NAO conducted surveys of departments' preparedness that reviewed, among other things, departments' accounting systems and policies and the extent of progress made on preparing opening balance sheets. NAO then found that while the majority of departments had made considerable progress some still had significant work to do.

During the first half of 1999, as part of trigger point 2, NAO conducted an audit of departments' opening balance sheets as of April 1, 1998, and a further assessment of departments' systems. They found that, in the main, balance sheets were reasonably complete, although they also found errors and omissions of varying size and significance. On systems, further progress had been made but some departments still have to develop fully certain elements necessary to meet all requirements. In NAO's view, the first full indication of departments' preparedness will be the audit findings on the 1998-1999 dry run accounts.

[18]The three "trigger points" identified by the government are as follows: (1) stage one approval—survey of departments' progress towards developing and implementing systems and policies to support resource accounting, (2) assessment of departments' opening balance sheets for 1999-2000, and (3) NAO's audit of departments' dry-run 1998-99 resource accounts.

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